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## **The institutional and political economy of Maastricht criteria**

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**ABSTRACT**

Fourteen years after its “technical” start on 1<sup>st</sup> January 1999 and eleven years after the entrance into force of the “full” monetary union with the physical introduction of euro coins and banknotes on 1<sup>st</sup> January 2002, the European Economic and Monetary Union (EMU) is facing the most severe crisis of its existence. Particularly affected, the public finance stance of some member states has become quite alarming, so that, it might jeopardize the whole monetary area. In that tense context, and in parallel to the several austerity programmes undertaken by, and/or imposed on, many governments, there have been serious calls for reforming the European Union’s (EU) restrictions framing the national fiscal policies. The doubts regarding the effectiveness of these supranational fiscal rules are however not new. Since they have been initially designed, the so-called Maastricht fiscal criteria have been indeed subject to a wide range of criticisms. Setting out from this premise, the present Master’s Thesis investigates the construction, as well as the functioning, of the EU instrument of fiscal discipline from a political and institutional perspective. Based on an economic theoretical framework, our research, after having specified the economic concept of “fiscal discipline”, provides a dynamic institutional reading of the EU legislative acts forming the fiscal constraint in force nowadays. More than just describing the provisions prescribed in these legal bases, our study carries a deeper analysis, which highlights the improvement made over the last twenty years, as well as the remaining shortcomings and inconsistencies contained within the European fiscal environment.

## INTRODUCTION

Fourteen years after its “technical” start on 1<sup>st</sup> January 1999, date which was marked by the transfer of control from the national central banks of the eleven qualified countries to the new and centralized European Central Bank (ECB), and eleven years after the entrance into force of the “full” monetary union with the physical introduction of euro coins and banknotes on 1<sup>st</sup> January 2002, the European Economic and Monetary Union (EMU) is facing the most severe crisis of its whole existence. Even though the single currency seems to have brought significant microeconomic gains for the members of the Eurozone over the years (Bénassy-Quéré *et al.*, 2008: 2), the seriousness of the current so-called sovereign debt crisis may objectively be able to jeopardize the whole EMU.

Began in October 2009, when Greece announced that its public deficit was in reality twice higher than previously reported, and followed by a succession of several austerity programmes all over the Eurozone<sup>1</sup>, the European crisis constitutes a crucial test for the future of the European monetary union and, to the extent, for the whole European construction. Although the euro area is customary of being under the fire of critics, it seems that the encountered difficulties have never been so deep than during these last months. For instance, tackling the issue of the risk of secession has become a conceivable scenario, not only for the mass media, seeking for alarming pictures, but also for serious academic observers<sup>2</sup>. More than just a cyclical problem, due to the tense economic situation and following upon the 2007-2008 global financial crisis, the troubles occurring among the EMU member states have confirmed the doubts expressed, already at the designing stage of the monetary union, by numerous economists, concerning the structural organisation and definition of the Eurozone.

Aside from the original distrust regarding the capacity of the European countries, in terms of their individual characteristics, to form an optimal currency area (OCA) according to the theoretical contribution of Mundell (1961), a wide range

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<sup>1</sup> Spain announced a first austerity program in January 2009, Portugal in March, Italy in July and Ireland benefited of a bailout package in exchange of austerity measures in November of the same year.

<sup>2</sup> See for instance the note provided by Feldstein (2008) describing the factors, which could lead to a potential break-up of the Eurozone.



of economists have questioned the institutional design of the monetary union, highlighting some strong inconsistencies and inefficiencies in its functioning, as well as its asymmetric architecture (Breuss, 2002: 586). This latter trend of opinions takes mainly its roots in what Rossi and Dafflon (2012) call the “original sin” of the Eurozone or, in other words, the interaction of a centralized monetary policy with uncoordinated national fiscal policies (Herzog, 2004: 3). The obtained result of highly politicized decisions and conflicting national interests about monetary and fiscal policies (Feldstein, 1997: 30) seems indeed to have neglected the numerous academic researches highlighting the relevance of centralizing a significant part of the national budgets to the European level.

During the Maastricht Summit in December 1991, the twelve member states of the newly called European Union (EU) made a crucial step forward in the history of European integration by scheduling the “second stage” implementation plan leading to the unique European currency. However, mainly for national sovereignty concerns, they opted for currency unification but rejected the idea of centralizing even partly their fiscal policy power<sup>3</sup>. Consequently, the establishment of a supranational monetary union in 1999 (the third stage) with the transfer of control from the national central banks of the qualified countries to the ECB marked the beginning of the interactions between sovereign countries, in terms of fiscal policy, and a single monetary authority managing the European monetary policy, a so-called “one-size-fits-all” monetary policy. Also referred as the “Brussels consensus”<sup>4</sup> (Bénassy-Quéré and Coeuré, 2010: 72), the strategy behind this distribution of competences is the following: the centralized monetary policy responds to the events having an impact on the Eurozone as a whole (symmetric shocks), whereas the national fiscal policies deal with the specific economic situations (asymmetric shocks). In order to grasp the consequences of this choice, the approach developed in the OCA theory, based on a cost-benefit analysis of a monetary union, offers a helpful framework. Concretely, this method consists in balancing the potential trade gains against macroeconomic losses

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<sup>3</sup> For the 2007-2013 period, the budget of the European Union amounts to 1.045 per cent of the Union’s GDP, whereas the budgets of public sector correspond, on average, to 40 per cent of GDP (Bénassy-Quéré and Coeuré, 2010: 70).

<sup>4</sup> This expression alluding to the well-known “Washington consensus”, in the 1980s, between the International Monetary Fund, the World Bank and the U.S. Treasury Department.

(Feldstein, 1997: 16).

By joining a monetary union, a country not only loses its national currency but also its sovereignty in terms of monetary policy. As a matter of fact, the transfer of this instrument of economic policy implies that the member states cannot operate individually any devaluation or revaluation of the currency, nor decide the supplied volume of money, neither set the short-term interest rate. Given that the ability for a nation to use these policy tools can be extremely useful, this shift of power constitutes the main cost side of a monetary union. Mundell (1961), in his seminal paper, illustrates for instance this cost by the adjustment problem that can occur in a single currency area, when facing an asymmetric shock in aggregate demand, possibly due to a specific sector specialization, to particular direction of national trade or to any social, as well as political event (Bénassy-Quéré *et al.*, 2008: 1). Through this example, we learn that international *wage flexibility* and *mobility of labour* serve as automatic mechanisms bringing back equilibrium and consequently, that the cost of the monetary union for its member states will be negatively correlated with the level of these two factors: the higher the wage flexibility and the mobility of labour, the lower the cost of the union. Furthermore, differences between member states among the union in terms of their preferences about inflation and unemployment, of their labour market institutions, of their legal systems or even of their growth rates represent other sources of disagreements (and of costs) on the way to formulate the centralized monetary policy<sup>5</sup>. More than just pointing out the costs related to the participation in such a union, the latter analysis provides interesting insights on the implications for the conduct of fiscal policy.

Mundell's example highlights indeed a direct link between monetary and fiscal policies. In case of an asymmetric demand shock within a monetary union, not only wage and labour flexibility would be required, but an insurance mechanism, allowing income transfers between the member states, would also be necessary in

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<sup>5</sup> De Grauwe (2009) provides a detailed analysis of the OCA theory and analyses its policy implications.

order to limit the social pain in the country facing the demand downturn<sup>6</sup>. Thanks to these transfers, the adjustment is made easier and softens the demand shift. This insurance system can be organized either through a centralized budget, which offers the advantage of automatically redistributing income among the member states (interregional insurance system), or, without centralizing government budgets, through intergenerational transfers. Considering first the relative inhomogeneity of the European countries, which makes asymmetric shocks more likely (Feldstein, 1997: 22), and second, the option chosen by the European member states – namely keeping independent national budgets – it means, in short, that a member state, hit by a demand shock, would finance its deficit with external debt and consequently, its future generations would have to pay for the current negative economic situation. In the latter case, the OCA theory implies thus that “a substantial autonomy should be reserved for these national fiscal policies” (De Grauwe, 2009: 224) even though it acknowledges that centralizing a significant part of the national budgets would be more desirable.

This conclusion, which recommends a high degree of flexibility and autonomy for individual national budgets in monetary union without budgetary centralization, has however to be tempered. Following such a strategy would completely neglect the potential issue of deficit sustainability and, quoting Buti *et al.* (2003: 100), “EMU without [fiscal] rules would be an interesting experiment, but a risky policy option”. Without entering for now into greater details, let us just remind that the accumulation of past deficits constraints the room of manoeuvre for future budgets. At a certain point, the use of fiscal policies to balance negative economic shocks is thus limited and requires running large primary budget surplus in the future. Therefore, the autonomy of the national fiscal policies is necessary in case of temporary shocks but, when facing a permanent negative shift of demand, and given the risk of unsustainable public finances, fundamental adjustments, for instance in terms of wages, are inevitable in order to offset the shock.

In a monetary union, the risk of seeing the sovereign debt of a member state becoming unsustainable implies further concerns and can have negative

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<sup>6</sup> See for instance Von Hagen and Wyplosz (2008), who analyse and confront two systems of collective insurance, namely tax revenue sharing and unemployment revenue sharing.

consequences for the whole union. A first implication of the fiscal policy unsustainability of an individual country comes from the negative *spillover effect*, which is spread on the other participants in the union. Theoretically, a country recording sizeable deficits over the years, through its interventions on the capital market (in order to finance its deficits), contributes to increase the enforced interest rates at the level of the union. The spillover is then double: the increase in the interest rate leads, on the one hand, to a higher debt burden for each member state and, on the other hand, to a greater political pressure on the central bank for relaxing its monetary policy, corollary effect of the general higher level of indebtedness within the union (Beetsma and Uhlig, 1999: 546; von Hagen and Eichengreen, 1996: 134). These negative spillover effects represent therefore a clear risk for the member states of a monetary union and constitute a first argument for limiting the degree of autonomy for conducting the individual national fiscal policies.

A second phenomenon, which has to be taken into account, when analysing the incidence of forming a monetary union on national fiscal policies, lies in the *moral hazard* issue. Traditionally, we consider that the interest rate, which the governments have to pay on their debts, results from the addition of the prices covering the risk of default as well as the risk of devaluation. Outside of a monetary union, the national level of indebtedness is directly correlated with the risk of currency devaluation. A growing stock of debt goes with an increase in the interest rate. Logically, if a country participates now in a monetary union, which means that this state cannot individually decide its monetary policy, it is not anymore its own degree of indebtedness that defines the risk of devaluation. The link between the national indebtedness and the interest rate on sovereign borrowing thus weakens. Furthermore, in a monetary union, the interest rate expressing the risk of default of a member state will most likely take into account the implicit guarantee of bail out. Unless the private capital market works efficiently and applies different interest rates in the union according to the individual national risks, highly indebted member state will benefit of lower interest rates than they would have outside of the union. In other words, because of the moral hazard, forming a monetary union reduces the incentives for national

governments to respect fiscal discipline and, here again, justifies less national sovereignty on the national fiscal policies.

This short presentation of what we can learn, from the economic theory, about the consequences, in terms of fiscal policy, of a monetary union like the Eurozone, namely without any significant “federal” budget, reveals the difficult trade-off on the degree of autonomy to be given to the member states. On one hand, the loss of the monetary instrument at the national level implies that the fiscal tools are the only ones left in the hand of each government to tackle economic slowdowns (de Grauwe, 2009: 224). Under this approach, the theory calls for more national autonomy and fiscal policy flexibility. However, on the other hand, taking into account the existence of spillover effects and the moral hazard issue leads to a quite different conclusion. From the latter standpoint, the monetary union not only creates a direct link between the national fiscal stances of each country, but also tends to relax the fiscal discipline by introducing wrong incentives at the national level. National fiscal policies free of any constraint and open to these policy biases would be thus highly risky for the long-term sustainability of the monetary union (Buti *et al.*, 2003: 100). The conclusion that we draw from these opposite theoretical insights is that a compromise has to be found. Confirming this viewpoint, Beetsma and Uhlig (1999: 561) show, through a stylised model investigating how a stability pact affects national debt policies, that governments, when forming a monetary union, are actually inclined to sign such a pact in order to “internalise the benefits of reducing the debt in terms of lower future inflation”. A recent empirical study, based on a panel of EU countries, tends to confirm the latter effect by demonstrating that the existence of fiscal rules seems to enhance economic growth (Afonso and Jalles, 2012: 5).

Taking into account the arguments of both positions, the European member states agreed on the imposition of a budget constraint. Defined for the first time in the Treaty on European Union (TEU), the design of the so-called Maastricht fiscal criteria has been indeed guided by the desire to reach an acceptable compromise between the two theoretical requirements. These budgetary rules – “comprising of reference values for deficits and debt to be achieved within a given time-span, a common accounting framework for computing public finance variables and a call

to adapt national procedure to the requirement of budgetary discipline” (European Commission, 1997: 47) – target to keep a certain room of manoeuvre for allowing the member states to run countercyclical fiscal policies and, at the same time, to limit the spillover effects and the moral hazard bias by setting limits on the annual deficits as well as on the size of the government debts. Another logic behind the criteria was, of course, to promote convergence between the future “euro time zone” members. Entered into force already on 1<sup>st</sup> November 1993, the criteria served, at first, as convergence conditions for participating in the monetary union<sup>7</sup>, despite the numerous shortcomings and painful impact that these requirements represent for these peripheral economies (Rossi, 2004: 968). Furthermore, once the Eurozone came fully into existence, this constraint on public finance has been reaffirmed and is called, since then, the Stability and Growth Pact (SGP). This instrument, adopted at the Amsterdam Summit in June 1997, was originally based on three legal acts: Council Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policy, Council Regulation (EC) No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure and Resolution of the European Council on the Stability and Growth Pact (97/C 231/01). Despite the succeeding amendments in 2005 and 2011, the essence of the latter institutional arrangement still consists in observing closely the national fiscal deficits and sanctioning the countries with excessive ones. Moreover, the two criteria concerning the public finances of the member states have been maintained over the years. The European legislation limits the general government deficit-to-GDP ratio at 3 per cent and the general government debt-to-GDP ratio at 60 per cent. If facing a fiscal stance beyond these reference values, a member state falls into the so-called “excessive deficit procedure”. Besides, the SGP stipulates, in its original version, that the member states should achieve and maintain a medium-term budgetary position “close to balance or in surplus”. In the successive amendments of the Pact, this requirement has been however slightly relaxed.

Outwardly simple in their formulation, these binding rules do raise several issues

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<sup>7</sup> These are still nowadays necessary to be fulfilled by the new applicants to the Eurozone.

concerning their application as well as their enforcement in practice. Moreover, the following examples attest of the possibility to evaluate the European budget constraint under a wide range of approaches. For instance, Dafflon (1997) highlighted some concrete problems when it comes to imagine a hypothetical implementation of the Maastricht criteria in a federal state such as Switzerland<sup>8</sup>. Other lines of doubts are mentioned in the literature like the one taken by Eichengreen and Wyplosz (1998: 69), who not only appeared to be quite pessimistic about the benefits of the SGP in terms of fiscal discipline, but also consider that this Pact may induce significant costs in “diverting political effort from more fundamental problems”. Noting the 2002-2003 enforcement difficulties encountered by the preventive arm of the SGP, Fatás *et al.* (2003: 8) attributed this failure to “a framework focusing on numerical values and lacking strong enforcement”. Some authors, among them Balassone and Franco (2000b) or Blanchard and Giavazzi (2004), stressed the problem of the public investments, which could suffer from the implementation of the SGP. Last but not least, de Haan *et al.* (2003: 3) questioned the degree of bindingness of this regulation, as well as the likelihood of the member states to stick to the legally non-binding rules contained in the Pact. Because of the many unclear definitions and unenforceable mechanisms, among other things, the European fiscal rules have always been subject to scepticism about the outcome that such limits can produce and, it is obvious that the present fiscal stance of many Eurozone member states tends to prove these sceptical observers right.

Contrary to the critics formulated against the general features of the SGP, for instance on the level of the deficit and debt ceilings<sup>9</sup>, we wish to focus here on the way the European budget constraint is institutionally designed. In other words, we take mainly into account the institutional framework in which the criteria are applied and try to highlight the relevance and the difficulty, which has been for long neglected by the economists, of the transposition of economic concepts into legal texts.

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<sup>8</sup> Balassone and Franco (2000a) also tackle the issue of the compliance with the SGP in the context of fiscal federalism.

<sup>9</sup> See, for example, the study provided by Uctum and Wichens (2000), who deem the 3 per cent deficit ceiling inconsistent with the cyclical economic activity and the 60 per cent debt ceiling infeasible with initial high indebtedness.

Since 1940 and during the second half of the XX<sup>th</sup> Century, the mainstream economics, represented by the Neoclassical thinking, has indeed essentially ignored the impact of the institutions on the economic process (Chavance, 2007: 4). The emergence of this paradigm is contemporary to the application of mathematical and statistical tools to all fields of sciences and, of course, Economics is no exception to this trend (Friboulet, 2009: 111). In the latter discipline, the influence of the general tendency is characterized by the formalization of the economic behaviours into mathematical models. In this context, the analysis of issues related to the budget policies became a matter of synthesizing the determinants of budgetary decisions into equations in order to easily grasp the logic behind them. For instance, the institutional framework is completely underestimated (if not ignored) to the benefit of strong hypothesis simplifying complex reality and behaviours (Novaresi, 2001: 1). Under this approach, the institutional environment, in which the decisions concerning public budget policies are made, is simply not relevant and is supposed to have no impact on the outcome of the budgetary process.

Contributing to challenge this way of thinking, different empirical researches<sup>10</sup> showed in fact, that economic variables alone cannot fully explain why some countries have accumulated large and persistent deficits in the last twenty years (Alesina and Perotti, 1995: 3). Given this observation, fiscal policy outcomes are found endogenous and obviously reflect “the interaction of different agents (policymakers, political parties, private sector) with possibly conflicting interests, rather than being chosen by a benevolent planner maximizing a social welfare function” (Milesi-Ferretti 1996: 1). Therefore, the environment, taken in its large meaning, may directly affect the budgetary process and consequently the quality of its performance. With the growing influence of the “new institutional economy” in the mid-1990s, the definition of the “rules of the game” plays, since then, a central role in the economic analysis. Parallel to this general trend, the political economy of fiscal institutions is no exception and “has emerged as a fascinating and lively field of academic research in the last decade” (von Hagen,

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<sup>10</sup> Kirchgässner (2001) provides for instance an empirical literature survey on fiscal institutions of the last three decades.



2005: 10), giving a relevant and practical insight into what impact fiscal rules have.

Following this viewpoint, the thesis defended in our study is that, not only “fiscal institutions do matter” (Poterba, 1996: Abstract), but they also have a positive impact on fiscal discipline, if well-defined (Alesina and Perotti, 1999: 33). The target of the present Master’s Thesis is then twofold. Indeed, it firstly aims at providing a detailed description of the “rules of the game” of the budget constraint set at the European level. Secondly, on the basis of the picture of the Maastricht criteria we draw, we wish to assess the quality of the set of rules in terms of fiscal outcome and highlight the inefficiencies contained in this institutional environment.

In order to reach this ambitious goal, our research is divided into two parts, containing each several chapters. Part I provides the economic theoretical background justifying the implementation of budget rules. Here, we theoretically tackle issues, such as budget discipline, government indebtedness or public sector size. An extra attention at the definition and the classification of “budget institutions” is also made. The logic guiding this whole opening part is the following: we start with the presentation of the pro and con arguments concerning budget discipline before looking at the reasons defending the transposition of the discipline into binding rules.

Building the second part on the previously exposed theoretical basements, we concentrate then our attention on the European case, the heart of our research. After having set our analytical framework and clarified some relevant fiscal concepts, we present a detailed description of the institutional environment guiding the functioning of the European fiscal restriction on the basis of the several legal texts. Starting with the rules designed in Maastricht in 1992, which consist in limiting public deficits and debts, we also try to give a global overview of the different rules surrounding these ceilings, as well as of their evolution through time. Here, the monitoring and reporting rules, the methods of sanctions, the decision-making process and all other “rules of the game” are analysed. Given this institutional framework, the last chapter of Part II goes deeper into the

analysis of the Maastricht budget constraint and provides an assessment of this fiscal instrument. From this assessment, we notice the institutional inefficiencies and the resulting behaviours.

A last introducing remark has to be mentioned before properly going to the heart of the matter. This study focuses its interest on the Maastricht criteria constraining the fiscal policies of the Eurozone member states. As previously noticed, this monetary union has been wished by its architects not to be accompanied by a significant centralized budget and, consequently to let a significant degree of national fiscal autonomy. In this context, it is important to keep in mind that the Maastricht budget constraint gives only a general budgetary framework, in which each government defines its own fiscal policy. Put differently, it means that budgetary institutions such as the budgetary process, the governance mechanisms, or the political system at the roots of the budgetary decisions are individually defined and therefore widely vary within the union. Furthermore, fiscal rules being in force at local and regional levels also strongly differ between states (Ter-Minassian and Craig, 1997: 169) as well as between jurisdictions within nations enjoying a certain degree of liberty in the definition of the rules in federal countries (Dafflon, 2002: 13). Consequently, focusing on the institutional design of the Maastricht criteria does not imply that the national and subcentral budgetary institutions have no influence on the fiscal policy outcomes of the member states.

## **PART I: Theory of budget constraint**

The first part defines the theoretical framework on which this Master's Thesis is based. Reviewing the theoretical arguments about fiscal discipline, we try to highlight and clarify the different issues linked to the question of the public sector budget constraint. Given the several problems, we show the expected theoretical impact of imposing rules on government fiscal behaviour.

Concretely, this part aspires to tackle three related issues and presents, for each of them, a theoretical analysis of their ins and outs. We begin with the complicated debate on fiscal discipline (Chapter 1). As pointed out by Novaresi (2001: 7), almost all scientific as well as political observers agree on the worth of the discipline taken in its large meaning. However, this general consensus does not remain when it comes to define precisely the concept of discipline and, to the extent, to arbitrate between the fundamental "trade-off between the elimination of a policy bias and the need to retain policy flexibility" (Milesi-Ferretti, 1996: 5). On one side of the debate, we find thus the partisans of a strict control of the fiscal balances (not necessarily on an annual basis) and, on the other side, arguments defending the relaxation of the constraints on deficits and debts.

The second step of this theoretical chapter deals with the issue of the transposition of the principles of fiscal discipline into legally binding rules (Chapter 2). Based on the arguments developed in the previous chapter, we consider first the normative approach. The resulting question is the following: is there any theoretical justification for introducing rules in order to guarantee fiscal discipline? Moreover, in the debate on the necessity of setting binding regulations, a further perspective can be investigated. The latter viewpoint, rather than focusing on the requirement of rules, looks at the expected outcomes that such instruments are likely to bring. This field of research concentrates thus on the potential effectiveness of the constraints. Quoting Rossi and Dafflon (2002: 37), "whereas the theory of balanced budgets focuses on efficient resource allocation and fiscal justice arguments, the practice of budgetary equilibrium relies on a more sophisticated line of reasoning, in which public choice arguments take centre stage".

Finally, Chapter 3 serves as a transition to the forthcoming descriptive analysis of the EMU budget constraint. Before proceeding to the institutional economy analysis of the European fiscal rules, we need indeed to define precisely the term “fiscal institution”. As stressed by Poterba (1996: 4), “budget rules” can refer to a wide range of fiscal institutions and therefore, a clear definition of them is required. More than just the exhaustive inventory of institutions, we also emphasise their theoretical role and their expected impact on the government fiscal outcomes. Taking into account all the institutions listed in the literature, we already restrict our domain of research by determining the relevant ones for this Master’s Thesis. In addition, this final theoretical chapter offers us a perfect opportunity to mention, in a last section, what we refer to as the “Swiss exception”. Switzerland, by providing popular initiative and referendum rights, constitutes indeed a special case in terms of its institutional environment and, for this reason, is worth to briefly present.

## 1 The debate on fiscal discipline

For long, the debate on fiscal discipline has been focused on the requirement of a strict control of fiscal balances. In this configuration, the question opposed, on one side, the partisans of a rigorous fiscal balance, rejecting to have recourse to public indebtedness, and, on the other side, the authors relaxing the absolute necessity of achieving the balance and, therefore highlighting the utility of borrowing; the former taking inspiration mainly from the Classical School of Economics and more recently from the Public Choice approach, whereas the latter are generally referred as members of the Keynesian School. Later, the assimilation of the concept of “fiscal discipline” with the notion of “fiscal balance” has been questioned, considering this interpretation as too rigid. Following this conclusion, the present chapter acknowledges that the arguments defending fiscal discipline do not necessarily refer to a strict annual fiscal balance, as well as fighting for relaxing fiscal discipline does not imply systematic fiscal deficits. In other words, we think that the protagonists of the debate cannot anymore be classified as being for or against fiscal balance (for or against public indebtedness), but that the opposition takes now place on the stringency of control, which is required. In this context, fiscal discipline refers to the enforcement of strict controls, whereas relaxing it suggests in fact letting fiscally more room for manoeuvre to governments.

Inspired by the logic developed in Novaresi’s Doctoral Dissertation (2001), this chapter exposes the debate on fiscal discipline and structures it according to Musgrave’s classification of functions devoted to the public sector<sup>11</sup>. Focussing successively on the resource allocation, income redistribution and macroeconomic stabilisation functions, we review, for each of them, the arguments of both, the partisans of greater budget discipline and the defenders of less rigorous controls. Contrary to Novaresi’s methodology, which dealt with the two opinions one after the other, we directly confront, in each section, the two opposed positions.

In order to clearly schematize, according to the above-mentioned logic, our discussion on fiscal discipline, Table 1-1 proposes a classification of both

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<sup>11</sup> For a global presentation of these fiscal functions, see Musgrave and Musgrave (1984).

opposed arguments, which are mostly cited among the economic literature. These several points represent the ideas, which we expose in this first theoretical part.

Table 1-1: *Main arguments for and against fiscal discipline.*

	For fiscal discipline	Against fiscal discipline
<b>1.1 Resource allocation</b>	Optimal size of public sector	Ricardian equivalence hypothesis
	Crowding out hypothesis	Argument against the crowding out effect
<b>1.2 Income redistribution</b>	Intergenerational transfer	Acknowledgement of the equivalence hypothesis (included in Section 1.1)
	Intergovernmental transfer	Lerner's model
<b>1.3 Macroeconomic stabilisation</b>	Implementation of expansionary fiscal policy	Functional public finance theory
	Political difficulties in the implementation of expansionary fiscal policy	Fiscal balance over the economic cycle
	Expansionary fiscal policy in the context of federalism	Automatic stabilisers

### **1.1 Resource allocation**

In order to maximize its welfare, the society has to use its endowment of scarce resources (labour, capital, technology, etc.) as efficiently as possible. Being allocated to the production function of public goods and services (managed by the public sector), part of these resources is not any more available for the private sector. The resulting equilibrium of this trade-off aims to reach what is commonly called the *allocative efficiency* and should lead to the optimal matching of the supply to the demand. Moreover, this function contains another aspect: the *productive efficiency*. Once the distribution of wealth between the private and the public economic activities is decided, the respective endowments have still to be

used efficiently, either maximizing the production with a given budget, or achieving the production goal at the lowest cost.

In the context of the debate on fiscal discipline, the arguments of both conflicting sides mainly come within the framework of the allocative efficiency. On the one hand, the partisans for a stricter fiscal discipline underscore firstly, the virtue of discipline for optimally defining the *size of public sector*, i.e. the optimal public endowment, and secondly, the risk linked to public indebtedness to make private investment more expensive and thus less productive (*crowding out hypothesis*). On the contrary, some authors reject the latter effect and, based on the rationality of the economic agents, consider financing through borrowing as equivalent as through tax (*Ricardian equivalence hypothesis*). Let us develop further these several ideas.

#### *1.1.1 Optimal size of public sector*

The first argument, from the resource allocation standpoint, calling for more discipline because of its important implication on the behaviour of economic agents, deserves a special attention.

In their textbook, Rosen and Gayer (2010: 474) make the following statement: “The discipline of a balanced budget may produce a more careful weighting of benefits and costs, thus preventing the public sector from growing beyond its optimal size”. Before investigating more closely the economic meaning of this argument, it seems relevant to formulate an introductory remark about the expression “optimal size”. The reader has indeed to note that it refers here to as the amount of resources, that the citizens are willing to allocate to public sector. Thus, this concept does not have the ambition to define a strict ideological public sector size in terms of the level of resources, which should be devoted to it. It rather emphasises the need of a decision-making process allowing rational decisions, namely taking into account not only the benefit of a given spending, but also its costs. In other words, the result, to which this process leads (large or limited public sector), is not the main question under consideration. From this perspective, the supporters of fiscal discipline stress the multiple advantages of financing public budget through tax instead of debt. We group these theoretical

gains into three categories: (1) the modality of resource transfer, (2) the responsibility towards the public indebtedness and (3) the potential strategic behaviours. In the following paragraphs, we develop the main features of these arguments.

As previously noted, the first advantage of fiscal discipline, as far as the definition of the optimal size of the public sector is concerned, lies in the *modality of resource transfer from the private to the public sector*. We distinguish three different reasons, giving weight to this argument.

Firstly, any rational decision requires having access to the relevant information. In the case of spending decision, the price is a necessary indication, allowing the direct comparison between the benefit coming from the acquisition of a given good or service and its cost. In context of policy programmes, this link may not be obvious, especially when public services are financed by debts. On the contrary, and because it implies that each new investment is financed by taxes, fiscal discipline reinforces the link between the public programmes and their cost. In this sense, taxes play the crucial role of “fiscal prices” of collective goods and services (Dafflon and Beer-Toth, 2009: 355). For instance, in marginal terms, fiscal discipline allows linking a new public task with its financial impact on the budget. Consequently, the decision of undertaking a new project, or developing further an old one, can be made, knowing its financial implication for taxpayers.

In the same vein, acknowledging the “ultimate inescapability of Budget Balance<sup>12</sup>” (Tollison and Wagner, 1987: 375), a government, when increasing its spending, can have recourse to four financial sources: taxes, user fees, financial transfers or government borrowing<sup>13</sup>. All imply a resource transfer from the private to the public sector, but according to different transmission modalities, creating distinctive behavioural effects among the economic agents (Dafflon, 1998: 68).

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<sup>12</sup> The expression refers to the observation that government revenues are always, at least equal to its expenditures.

<sup>13</sup> The economic literature sometimes completes this list with another source of financing: the opportunity imputed to governments to implement an expansionary monetary policy. We deliberately exclude this method of financing since the member states of the EMU, by definition, have lost their sovereignty in terms of monetary policy.



In order to compare the impact that these several sources of government revenues may have on the decisions made by the agents, the economic literature suggests analysing them according to two criteria, answering to the following questions:

- Is the considered financial transfer *explicit* or *implicit*?
- Is this transfer *simultaneous* to the expenditure it serves to cover? (Dafflon, 1998: 68-72).

The reasoning behind this analytical framework is based on the fundamental conditions allowing making *rational* spending decision or, in other words, restraining *fiscal illusion*<sup>14</sup>. Table 1-2 presents the result of the analysis for the four sources of revenue. For instance, when a new public spending is financed through taxes, the resource transfer is considered explicit, i.e. the cost of the given expenditure is explicitly reflected in the increase in the amount of taxes. Moreover, this transfer is also simultaneous, which means that the payment and the benefit obtained through the new public programme occur at the same time period. By improving the coincidence of the decision-makers, the payers and the beneficiaries, taxes, and even more user fees, can play their role of fiscal prices. As a consequence, it reinforces the rationality of the spending decision.

Table 1-2: *Analysis of the financing methods of the public sector.*

Methods of financing	Payment		Financial coverage
	Explicit	Simultaneous	
Taxes	Yes	Yes	Hard budget constraint
User fees	Yes	Yes	The “user-pays” principle
Financial transfers	No: the members of other groups	Yes	The “user-pays” principle is relaxed
Government borrowing	Fiscal illusion	No: future generation	Soft budget constraint

Source: Dafflon (1998: 72).

In contrast, when a government budget records a deficit, meaning that part of its expenditures is covered by debt, the transfer becomes *implicit* and *delayed*. Thereby, the link between the cost of a given policy programme and its benefit is

<sup>14</sup> Clearly illustrated by Buchanan and Wagner (2000 [1977]: 93-98), the theory of fiscal illusion states that the perception of the voters, as far as fiscal implications are concerned, is biased. It appears indeed that the benefits of public expenditure are typically overestimated, whereas their fiscal costs are underestimated.

broken (Novaresi, 2001: 16), which may create a fiscal illusion and thus a weakening in the rationality of the decision-making.

Dafflon (1998: 72-73) develops one last argument, demonstrating the virtue of fiscal discipline in the manner of transferring resources from the private to the public sector. The economist highlights indeed the simplicity of the transfer rule provided by the fiscal discipline. Contrary to the potential alternatives, for example “the balance over the economic cycle” or “the opportunity cost of public spending”, fiscal discipline, meant here in its strictest sense, is not subject to forecasting or measurement difficulties.

The second phenomena, which makes the achievement of the optimal size of the public sector more likely under fiscal discipline, lies on the notion of *responsibility towards public indebtedness*. Whereas each individual is fully and personally responsible for the debts he owns himself, the accountability of public indebtedness falls to the society as a whole. Moreover, “while full discounting may take place for those individuals who own income-earning assets, this reasoning cannot be extended to individuals who own no assets” (Buchanan, 1958: 45). For the taxpayers, this lack of personal answerability makes government borrowing less costly than taxes (Novaresi, 2001: 17). Logically, the taxpayers are therefore willing to support public tasks financed by debt. Concretely, public borrowing means that a taxpayer, who would envisage leaving the jurisdiction in the future, could today benefit from public services without having to bear their costs. As a consequence of this incentive, it is predictable that the size of public sector would go beyond its optimal dimension.

The last aspect of fiscal discipline, improving the achievement of the optimal size of the public sector, concerns the potential *strategic behaviours adopted by the economic agents* in the context of rent seeking. According to the school of Public Choice, the fiscal policy outcome results from the interaction of different groups (politicians, citizens, lobbies, or bureaucrats), defending their own interests. Thereby, each interest group tries to take advantage of the negotiation, in the sense of the theory of “the concentrated benefits and the dispersed costs”. Here, the harder the government budget constraint, the weaker the influence of these

rent-seekers. While relaxing the budget constraint allows the government answering the demand of any group, without reducing its financial endowment to the others, or increasing taxes (Novaresi, 2001: 18), fiscal discipline establishes a competition between the several rent-seekers and their spending wishes and constraints the government to set an order of priority.

Likewise, taking into account Niskanen's famous hypothesis about the utility function of the bureaucrats<sup>15</sup>, it appears that fiscal discipline, by making the several bureaus compete with each other during the budget formulation process, contributes to control more efficiently the growing tendency of the government budget. In a jurisdiction, where fiscal discipline prevails, namely bounded by a hard budget constraint, the bureaus (the agents) would be more willing to reveal their truth production function through the negotiation process with the executive (the principal). We conclude that fiscal discipline presents the advantage of limiting the withholding of information implied in the well-known principal-agent relationship. Confirming this last argument inspired by the public choice approach, Dafflon (1998: 74-75) considers that, because of the lack of a harder fiscal discipline, the conjunction of the political pressure coming from the bureaucrats and the multiple interest groups explains a major part of the recurrent deficits encountered in the developed countries since the 1950s.

### *1.1.2 Crowding out hypothesis*

“The assumption that government borrowing reduces private investment plays a key role in the neoclassical analysis. It is referred to as the crowding out hypothesis – when the public sector draws on the pool of resources available for investment, private investment gets crowded out. Crowding out results from changes in the interest rate. When government increases its demand for credit, the interest rate, which is just the price of credit, goes up. But if the interest rate increases, private investment becomes more expensive and less of it is undertaken” (Rosen and Gayer, 2010: 469). According to this point of view, public borrowing creates a distortion in the resource allocation between the public and the private sector and consequently, slows the economic growth because of its

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<sup>15</sup> According to this author, the utility function of bureaucrats is maximized with the maximisation of the budget allocated to their bureau or agency.

negative effect on investment<sup>16</sup>. Furthermore, Dafflon (1998: 73) points out that, not only the allocative efficiency, but also the productive efficiency of the public sector can be victim of the crowding out effect. Borrowing implies indeed the regular payment of interests and of amortisations of the debts, which are unproductive financial commitments, and consequently divert part of the resources allocated to the public sector<sup>17</sup>.

However, as far as we consider this effect when conveyed by public spending, it has to be emphasised that the size of the crowding out still depends on the nature of the expenditures, which are financed through borrowing. The crowding out hypothesis becomes indeed less relevant if the deficit, covered by the debt, is allocated to public investment expenditure, rather than to current public consumption (Novaresi, 2001: 20).

Despite the fact that, at first glance, this hypothesis seems to be relatively easy to test<sup>18</sup>, empirical studies show that the relationship between both variables is not as clear-cut as it looks because of the impact of other components on interest rates. For instance, Rosen and Gayer (2010: 469) observe that, during the economic slowdown encountered in 2008 and 2009, low interest rates (because of the fall of investments) went with increasing public deficit; in this case, the correlation, being not the causality, says in reality nothing about the concerned hypothesis. From these econometric difficulties, the authors, without entirely rejecting the negative effect of public deficit on private investment, conclude that its partisans could overestimate its size in terms of capital stock reduction. Confirming this scepticism regarding the positive correlation between the public deficit and the interest rate, Rossi and Dafflon (2012: 114) recently show the irrationality of the financial markets in this respect. Looking at the long-term interest rate paid by EMU member states from 2000 to 2011, it appears that these countries, in spite of

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<sup>16</sup> Presenting in greater details the different channels, through which this theoretical effect occurs, is not the main purpose of our Thesis. Therefore, let us just mention that the economic theory considers three mechanisms: through the interest rates, through the quantitative rationing on capital market and through the impact of public deficit on expected inflation (Greffé, 1994: 416-418).

<sup>17</sup> As we further develop in Section 1.2, this phenomenon also contains a redistributive effect, namely between the current and the future governments.

<sup>18</sup> A positive and significant correlation between the interest rate and the public deficit would prove the occurrence of the effect.

recording quite different evolution of their public finances, face in reality the same interest rate until 2008.

Now, we turn to the two main “allocative” arguments, advocating the necessity of relaxing fiscal discipline: the so-called Ricardian equivalence hypothesis and, based on this assumption, the response to the above-mentioned crowding out effect.

### *1.1.3 Ricardian equivalence hypothesis*

The first argument supporting the relaxation of fiscal discipline is here firstly approached from the resource allocation perspective. Since it has important implications for the two other public sector functions (especially for the redistribution function) and for a matter of simplicity, we directly expose those in the present section.

The Ricardian equivalence hypothesis concretely consists in considering that the financing by tax is actually equivalent, in terms of economic impact, as it is by loan. If so, and since incurring debt or raising taxes do not ultimately matter, the debate on fiscal discipline loses its sense and becomes meaningless. Although this argument has been introduced by David Ricardo (1951a: 244-249; 1951b: 185-200) and therefore takes generally his name, the famous British economist was himself sceptical about the veracity of his hypothesis because of its strict dependence on its assumptions. Let us develop further the logic lying behind this argument as well as the conditions it requires.

The Ricardian equivalence is built on one fundamental assumption: the rationality of the taxpayers<sup>19</sup>. Given the “ultimate inescapability of budget balance” that we mentioned previously and the postulation of rationality, Barro (1974), in his seminal paper, develops a model, in which the current generation is aware of the future costs (deferred taxes) implied by today’s government borrowing. As a consequence, when a jurisdiction incurs new debts, its taxpayers anticipate the forthcoming tax growth and increase the share of personal income they save.

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<sup>19</sup> Note that Ricardo already tempered the assumption of taxpayers’ rational expectation: “The people who pay the taxes never so estimate them, and therefore do not manage their private affairs accordingly” (Ricardo, 1951b: 186).

“Therefore, the substitution of a budget deficit for current taxes (or any other rearrangement of the timing of taxes) has no impact on the aggregate demand for goods. In this sense, budget deficits and taxation have equivalent effects on the economy” (Barro, 1989: 39).

As mentioned previously, the acknowledgement of the Ricardian equivalence induces a further implication regarding intergeneration redistribution. Whereas some authors consider that indebtedness produces a transfer of burden between present and future generations (Section 1.2), following Ricardo’s hypothesis and the rational anticipation of the taxpayers leads however to the conclusion that “each generation consumes exactly the same amount as before the government borrowed” (Rosen and Gayer, 2010: 470). Consequently, fiscal discipline is not required.

However, this formulation is not without raising some question marks challenging its allocative, as well as redistributive, implications. One of the objections has to do with the temporal horizon of the taxpayers, which is most likely shorter than the one of the public debt, and has thus an impact on their behaviours (Novaresi, 2001: 31). In order to circumvent the issue, the author builds a model of “overlapping generations of persons with finite lives” (Buchanan, 1976: 337), making each individual “a part of an extended family that goes on indefinitely. In this setting, the households capitalize the entire array of expected future taxes, and thereby plan effectively with an infinite horizon” (Barro, 1989: 40).

This provocative theorem, stating the irrelevance of fiscal policy, has not passed unnoticed among the economic literature and has been subject to a wide range of criticism attacking the large number and the strength of the underlying hypothesis necessary to validate the model<sup>20</sup>. Moreover, even if we accept the equivalence hypothesis between taxation and borrowing, the question of the choice between the two financial sources remains open. In fact, and as acknowledged later by Barro himself, a theory of public debt creation is still missing.

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<sup>20</sup> Novaresi (2001: 32) discusses the six conditions *necessary* to maintain the Ricardian equivalence (among them, the rational expectations, the efficiency of the capital market or the altruistic link between generations) and concludes that the required conjunction of all these unrealistic assumptions seriously limits the concrete scope of the theorem. See also Buchanan (1976), or Templeman (2007: 439).

#### *1.1.4 Arguments against the crowding out effect*

As we have already mentioned, the crowding out hypothesis, because of the econometric difficulty of isolating its effect on the evolution of the interest rate, does not benefit from strong and clear-cut empirical evidences. Moreover, some economists have advanced different theoretical arguments questioning the existence of this effect, according to which public indebtedness would negatively influence the formation capital stock, and therefore calling for more discipline. Following Novaresi's classification (2001: 34-35), we distinguish four main ways of criticism.

The first argument, challenging the existence of a positive correlation between public deficit and interest rate, takes its roots in the equivalence hypothesis. In fact, if one admits the rationality of the economic agents, as the Ricardian equivalence defines it, any public deficit, i.e. any increase in public indebtedness, should be perceived by the taxpayers as an equivalent increase in the future taxes to be paid. According to this logic, and as we have developed it before, the following rational reaction of taxpayers would be to save enough money today in order to pay tomorrow the expected amount of extra taxes due for the new debt. As a result of the increase in the personal savings, the supply of capital, available for borrowing, remains unchanged. On the capital market, the supply decreases in the amount of money equal to the new public debt, but increases equivalently because of the new private savings. The interest rate, as well as the private investment, does not suffer from any negative impact. However, it is important to emphasise that this development lies on an implicit hypothesis regarding the capital market. The present argument indeed holds only if the interest rate offered on savings is equal to the one, which is charged to the borrowers. Relaxing this premise and, for instance, setting the plausible assumption that the interest rate on loans is in reality higher than on savings, the money saved by the rational taxpayers does not corresponds anymore to what is due to pay back the debt and its interests.

Secondly, the impact of public borrowing seems to differ according to the purpose of the incurred debt. While financing current public consumption by debt could

probably lead to crowd out private investment, loan financing *productive* public investment, enhancing economic growth and capital accumulation, turns out to invalidate the hypothesis in question. This issue, dealing more specifically with redistributive concerns, is further developed in the next section.

The two last arguments look more precisely at the situations in which public and private demands compete on credit market – essential condition for the validity of the crowding out hypothesis. Following the previous example of the recession of 2008-2009, some authors consider that the effect can exist only when the economy fully employs its resources. During an economic slowdown, an increase of the debt incurred by the public sector does not imply a decrease of the supply available for the private agents.

Finally, according to a last argument, the crowding out hypothesis holds as far as the public debt comes from domestic bondholders. On the contrary, if the capital, financing the public indebtedness of a given state, is levied on foreign credit market, the public demand for money does not compete anymore with the private demand. In this case, the crowding out hypothesis can logically be relaxed.

## **1.2 Income redistribution**

The second public sector function deals with the maximisation of the social welfare and its distribution among the members of the society. Whereas the resource allocation efficiency implies a certain distribution of capital and income among the individuals of the group, there is no guaranty that the resulting outcome, although Pareto-efficient, does fulfil the criteria of justice or fairness defined by the given society. If the allocative equilibrium does not match these conditions, which, by the way, involve “considerations of social philosophy and value judgement” (Musgrave and Musgrave, 1984: 12), the obtained social welfare is then under-optimal and can consequently be improved through a governmental intervention<sup>21</sup>. In addition, more than the unique issue of distribution among the different agents of a society, the optimal income redistribution contains also a “time dimension”, raising the question of the

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<sup>21</sup> For instance, the government can provide subventions to certain types of private production, or modify private agents’ income through taxes or fiscal deductions.



“intergenerational equity”. As pointed out by Musgrave and Musgrave (1984: 99), under certain circumstances, “present generation benefits the future one”, for instance through the bequest of the accumulated stock of capital, whereas, in other cases, “exploitation of irreplaceable natural resources and destruction of the environment place a burden upon the future”. As far as public debt is concerned, it is the latter dimension that requires our attention, namely the distribution (or not) of the burden induced by government borrowing. This distributive approach of the public debt has led to numerous discussions and controversy among the economists; the key question lying on the “possible shiftability or nonshiftability of the debt burden in time” (Buchanan, 1958: 34). Logically, the partisans of fiscal discipline answer in the affirmative and see public indebtedness as an *intergenerational*, as well *intergovernmental transfer of burden*, while the opponents refute it, advocating firstly the *equivalence theorem* (previously discussed in Subsection 1.1.3) and secondly, the absence of intergenerational transfer when each generation is considered as a whole (*Lerner’s model*).

### 1.2.1 Intergenerational transfer

In order to investigate the economic sense of public debt from the redistributive perspective, Musgrave and Musgrave (1984: 691) recommend distinguishing two separated issues: the *feasibility* of burden transfer and its *justification*. Whereas the justification, under certain conditions, enjoys a broad consensus among the scientists, the feasibility or, more precisely, its occurrence is questioned.

Regarding the justification of transferring the burden of the public debt, Musgrave (1959: 558-564) develops the so-called “*pay-as-you-use*” principle, which clearly shows when such transfers are economically appropriate; the criteria lying on the durability of the benefits provided by the public expenditures. In case of durable public goods, i.e. they produce benefits over several fiscal periods, the transfer of a part of the burden to the future recipients becomes desirable. Concretely, whereas current public spending does not justifies any burden transfer, public investments in durable goods, such as public infrastructures, does because of the objective of the coincidence of the payers with the beneficiaries. Each generation, who “consumes” a given public service, should pay for its own share.

Now we turn to the more debated issue of the real existence of the burden transfer. With his book treating the impact of government borrowing, Buchanan (1958), awarded by the Nobel Prize in 1986<sup>22</sup>, appears as the modern economist who contributed the most to the rehabilitation of the classical opinion arguing that public debt induces redistributive effects on future generations (Novaresi, 2001: 22-23). In order to defend his main proposition stating that the real burden of government borrowing is postponed to future generations, Buchanan (1958: 40) investigates the following simple question: “Who suffers if the public borrowing is unwise and the public expenditure wasteful” or, in other words, if the given loan-financed expenditure does not provide any durable benefit? As we discuss later, when developing the Lerner’s model, which comes from a Keynesian inspiration, the analytical approach taken by Buchanan, paying attention to the impact of the debt on individual utilities (*sacrifices*), rather than on macroeconomic variables<sup>23</sup>, differs from the latter, and leads to a quite different conclusion.

Defining the notion of “future generations” as “any set of individuals living in any time period following that in which debt is created” (Buchanan, 1958: 35) and considering the above-mentioned wasteful public project financed by debt, the author successively examine the three groups (bondholder, the taxpayer in  $t_0$  and the future taxpayer), potentially bearers of the primary real burden of the government borrowing.

As far as the bondholder and the taxpayer in  $t_0$  are concerned, the economist concludes that none of them does face any sacrifice. Indeed, “if an individual freely chooses to purchase a government bond, he is, presumably, moving to a preferred position in his utility surface by doing so” (Buchanan, 1958: 35). Moreover, this economic agent is thenceforth assured of obtaining a future income. Regarding the taxpayer in  $t_0$ , the argument pointed out by Buchanan relies on the fact that, at this period of time, none of his fiscal contribution serves to pay for the wasteful public expenditure. Inevitably, the real burden of the

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<sup>22</sup> This distinction awarded officially his seminal contributions to public choice theory.

<sup>23</sup> “In an individualistic society which governs itself through the use of democratic political forms, the idea of the “group” or the “whole” as a sentient being is contrary to the fundamental principle of social organisation” (Buchanan, 1958: 36).

public debt remains entirely to the future taxpayer. As a matter of fact, the latter is constrained to refund the bondholder and does not benefit from any public asset (since the considered expenditure was wasteful), which would compensate his monetary sacrifice.

Two remarks should be added to this argument. Firstly, the conclusion obtained from this perspective does not contradict the fact that the transfer of the burden can be justified. Following Musgrave's "pay-as-you-use" principle, if the concerned public expenditure produces benefits to several generations of taxpayers, the coincidence of circles of the payers and the beneficiaries calls actually for a transfer of the burden over the periods. The second remark also refers to the matching of two circles: the decision-makers and the payers. Buchanan's example implies the potential divergence between the ones who decide the public programme, and the others who bear its cost. In conclusion, the indebtedness of any jurisdiction induces a loss in terms of autonomy of choice. In fact, on one hand, the yearly payment of the service of the past debts reduces its financial capacity of undertaking new policy programmes (loss of budgetary autonomy) and, on the other hand, public investment decided in the past may not correspond to the preferences of future generations (loss of decisional autonomy).

### *1.2.2 Intergovernmental transfer*

As emphasised by Musgrave and Musgrave (1984: 689), "to service the debt, interest must be paid. Taxes raised to finance these payments impose a burden on the economy". Put differently, it means that the public debt incurred today implies a financial constraint on tomorrow's public budgets; this phenomena inducing a redistributive impact (Novaresi, 2001: 24). Extending this reasoning from a public choice point of view, Dafflon (1998: 73) observes that, if fiscal discipline is relaxed, a government could easily impair the financial resources of the succeeding one. Being constrained to use a large part of fiscal revenues to serve the existing debts, the forthcoming political decision-makers lose the power of undertaking new projects.

Note however that this argument does not call for a complete prohibition of public debt. According to the partisans of fiscal discipline, the fundamental decision

criteria, which determines the source of financing, lies on the nature of the expenditure. Whereas current revenues must finance current consumption spending, according to the “pay-as-you-use” principle, public investments, when producing benefits over several fiscal periods, can be burdened by debts.

### *1.2.3 Lerner’s model*

The position of the “new orthodoxy of the public debt”, as Buchanan (1958) names the fiscal discipline scepticism prevailing in the 1940s and 1950s, does not analyse the burden of the debt according to the same approach as the Classical Economics or the School of Public Choice. The focus of the authors, inspired by Keynes’ contributions, takes place on the macroeconomic aggregates, rather than on the microeconomic utility functions. Therefore, the argument we expose now does not provide a direct answer to Buchanan’s above-mentioned position<sup>24</sup>.

Under the condition that the government borrows from the members of its own jurisdiction (a so-called *internal* debt<sup>25</sup>) and, looking at the burden of the debt in terms of resources that are withdrawn from the economy as a whole, Lerner observes that borrowing creates no burden on future generation (Rosen and Gayer, 2010: 466). From this purely monetary perspective, it is only at the initial period (when the debt is incurred) that the economy bears a real cost, which corresponds to the amount of resources (production factors) necessary to undertake the public expenditure.

However, this model suffers from two major limitations. The first one consists in the fact that this reasoning is coherent only as far as internal debt is concerned. However, it appears that, in developed economies, the share of government borrowing financed from abroad is significant. For instance, Rosen and Gayer (2010: 466) report that, in 2009, foreign investors hold 54 per cent of the federal

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<sup>24</sup> While exposing his analysis of the economic impact of government borrowing, Buchanan criticizes strongly the use of a macroeconomic approach to treat this issue. For him, such reasoning, i.e. focusing on “the national or community balance sheet rather than on individual or family balance sheets”, makes a fundamental mistake: “The effect [of public debt] in the national balance is operationally irrelevant. [...] The nation or community is not a sentient being, and decisions are not made in any superindividual or organic way. Individuals and families are the entities whose balance sheets must be examined if the effects on social decisions are to be determined” (Buchanan, 1958: 41).

<sup>25</sup> On the opposite, the economic literature speaks of *external* debt when it is due to foreign creditors.

debt of the United States (US). In the case of external debts, the same analysis shows the existence of a real burden on future generation.

The second objection, valid for external as well for as internal debts, lies on the burden on future generation that represents the payment of the interest. Musgrave and Musgrave (1984: 689) indeed point out that, even if “we own the debt to ourselves” (case of internal debt), the taxes raised by government to pay the interests places a burden on the economy. “Conceivably, [the burden] becomes so large as to pose a serious burden and disincentive problem, a factor, which is overlooked in the “we owe it to ourselves” proposition”. These two fundamental limits of the Lerner’s model further confirm the existence of a redistributive impact of the public debt. Besides, they reinforce the position of the partisans of fiscal discipline.

### **1.3 Macroeconomic stabilisation**

The last public sector function concerns the intervention of the government in order to smooth the economic fluctuations; fiscal policy being here considered as an instrument of macroeconomic policy. The public sector contributes then to correct macroeconomic disequilibria, when the market forces are not able to solve them spontaneously. In this context, “fiscal policy must be designed to maintain or achieve the goals of high employment, a reasonable degree of price level stability, soundness of foreign accounts, and an acceptable rate of economic growth” (Musgrave and Musgrave, 1984: 13).

Up to the 1930s and before Keynes’ propositions, the fiscal economic research was mostly dedicated to the impact of budget policy on the two first public sector functions. With the Keynesian School, which focused on the aggregate demand and its link with the level of employment, budget policy turned out to be a strategic policy instrument, expected to be able to mitigate unemployment (Musgrave, 1985: 46).

In these circumstances, it appears more accurate to begin, for once, with the presentation of the arguments calling for a relaxation of fiscal discipline, before turning to the several objections they have raised among the strictness enthusiasts. This construction justifies itself, particularly since, as far as the stabilisation

function is concerned, there is no strict argument supporting fiscal discipline (Novaresi, 2001: 26)<sup>26</sup>. However, the defenders of a more rigorous control of fiscal policy, focusing on how the Keynesian tools could be implemented concretely, underscore the multiple difficulties, which make these theories less effective in reality.

Let us thus take a look at the three theories emphasising the necessity of giving enough room for manoeuvre to fiscal policies. All three drawing inspiration from the Keynesian approach, they have in common their acknowledgement of the requirement for the public sector to run anti-cyclical fiscal policy. However, they may differ on the degree of freedom they recommend to grant to the government.

### *1.3.1 Functional public finance theory*

According to this theory, public finances serve a unique goal: to keep aggregate demand at the desired level, and that, regardless of the impact on public deficits and indebtedness. The proposition of functional finance is guided by the idea stating that, in period of economic turmoil, part of the resources (capital and labour) stays unemployed and, therefore, are attached to a low opportunity cost. For this reason, public expenditure can divert these resources from the private sector and, by doing so, contributes to help the economy return to a level of full employment<sup>27</sup>. From this perspective, balancing the budget remains completely ignored (Rosen and Gayer, 2010: 473).

### *1.3.2 Fiscal balance over the economic cycle*

Whereas fiscal policy should still provide stimulus for the economy in situation of recession, this second Keynesian approach appears less extreme. Contrary to the functional public finance theory, the balance of fiscal policy is not entirely rejected. In fact, although the basic idea comes from the same line of thought, this theory considers that, once the economy, benefiting from the public boost

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<sup>26</sup> Note however that, in a recent working paper, Afonso and Jalles (2012: 1), conducting an empirical study on the relevance of fiscal rules for economic growth, put into light the virtue of discipline for preventing “policymakers from exacerbating macroeconomic volatility, which is known to be detrimental to output growth”.

<sup>27</sup> Note however that, in a recent study, Alesina *et al.* (2002) develop a model, which provides evidence for the so-called “non-Keynesian” effects of public spending. Contrary to the Keynesian perception of government expenditures, these authors show a significant negative impact of public spending on economic growth, especially through the pressure it puts on labour market.

(financed by deficits), returns on a positive growth path, fiscal policy should then record fiscal surpluses. The balance is then achieved over the economic cycle by using these surpluses in order to compensate the debts incurred during the slowdown.

It is thus interesting to note that, according to this viewpoint, expansionary fiscal policy is tolerated only when productive resources are not fully employed. In other words, nothing justifies public deficits in situations of economic prosperity.

### *1.3.3 Automatic stabilisers*

Although it is also based on the belief that the fiscal policy contributes to smooth the economic cycles by reducing their volatility, this last theory distinguishes from the two preceding by highlighting the automatic ability of fiscal policy to perform well its stabilisation function, making any discretionary government intervention useless (Novaresi, 2001: 41). This proposition takes its root on the observation of the *anti-cyclical* aspect of several components of fiscal policy, meaning that it reacts automatically to the economic situation. For example, if we observe the fiscal revenue collected from income taxes, we easily understand its dependence on the level of prosperity achieved by the economy. In time of recession, the income of the economic agents, subject to taxation, globally decreases. Their tax bill consequently does the same. When the economy grows, the opposite occurs. This reasoning can also be applied to several public expenditures, which tend to grow during a slowdown and decrease otherwise. It is typically the case of social security programmes such as the unemployment insurance. Given these anti-cyclical components of fiscal policy, the theory of automatic stabilisers recommends therefore to constitute a so-called “rainy-day” fund with the surplus recorded during periods of economic prosperity; the latter allowing to compensate the fiscal unbalances undergone during economic slowdowns.

Without considering the implementation difficulties of such policy yet, it is however enlightening to note that this argument strongly rely on the ability in forecasting the economic cycles. Unfortunately, it must be stated that, even

nowadays, economic cycles are rather retrospectively observed than successfully predicted.

Having briefly developed the main arguments calling for a relaxation of fiscal discipline, let us have a look at what their opponents would retort in order to defend the high value they attach to fiscal discipline.

#### *1.3.4 Implementation of expansionary fiscal policy*

As already mentioned at the beginning of the present section, the arguments questioning the effectiveness of the Keynesian approach do not focus on the coherence of the reasoning. They rather point out the several difficulties encountered when it comes to concretely implement such policies.

The first argument emphasises the “logistical” challenge of implementing expansionary fiscal policies. In fact, such investment programmes, supposed to boost the aggregate demand and therefore the economy, appear not so easy to undertake in an acceptable time period. In fact, the required time interval from the definition of the project, to its approbation, and its concrete implementation, may be extremely long. Therefore, the optimal functioning of Keynesian fiscal policy implies to possess reliable forecast on the economic trend in order to adequately anticipate the cycles. However, mainly because of statistical difficulties, such exercise is not as straightforward as it seems at first glance.

In addition to the difficulty of matching stimulus programmes to the economic situation, it must be noted that public investment expenditures generally represent only a small part of the total amount of public spending. Since the major portion of the public budget serves to finance current expenditures, the room for manoeuvre left to the implementation of cyclical fiscal policies remains therefore quite thin. For instance, looking at the Swiss figures (purple line in Figure 1-1), it appears that the investment-to-total-expenditure ratio of the public sector (Confederation, cantons and municipalities) varies between 9 and 12 per cent only.



### *1.3.5 Political issues in implementing expansionary fiscal policy*

The second argument tackles the political feasibility of the Keynesian fiscal policy, especially the target of balancing the budget over the cycle, and justifies its doubts with considerations based on the approach of public choice. From this analytical framework, the present argument detects an asymmetry in the implementation of the Keynesian principles: “deficits will be created frequently but surpluses will materialize only rarely” (Buchanan and Wagner, 1978: 4).

For the authors of the School of Public Choice, the government is not perceived as a benevolent social planner but rather, as a set of politicians having their own interests, among them, being re-elected. Because of this political competition, the behaviour of the politicians in office changes. For this reason, although these economists acknowledge the coherence of the Keynesian analysis as far as the politicians are benevolent agents, defending only the interest of the society, it appears that the fiscal policy outcome varies quite radically when the latter assumption is relaxed. Quoting Tempelman (2007: 442), “The tendency in elective democracy is for utility-maximizing politicians to borrow and spend rather than to tax and spend, and to spend much rather than little”. As a result, in a period of economic slowdown, the Keynesian recommendations would be easily implemented but, when the economy returns to prosperity, there is a low likelihood that the government either reduces its financial intervention, or increase the taxation. Given this asymmetric political behaviour, the debt, resulting from the deficits cumulated during the recession, has low chances to be paid back. “Politicians are more willing to spend than to tax” (Novaresi, 2001: 29).

### *1.3.6 Expansionary fiscal policy in the context of federalism*

Last but not least, the Keynesian approach of fiscal policy raises finally the issue of its interpretation in the context of a federal decentralized government. As recommended by Musgrave and Musgrave (1985: 515-516), the “responsibility for stabilisation policy has to be at the national (central) level”. Two main reasons justify this statement:

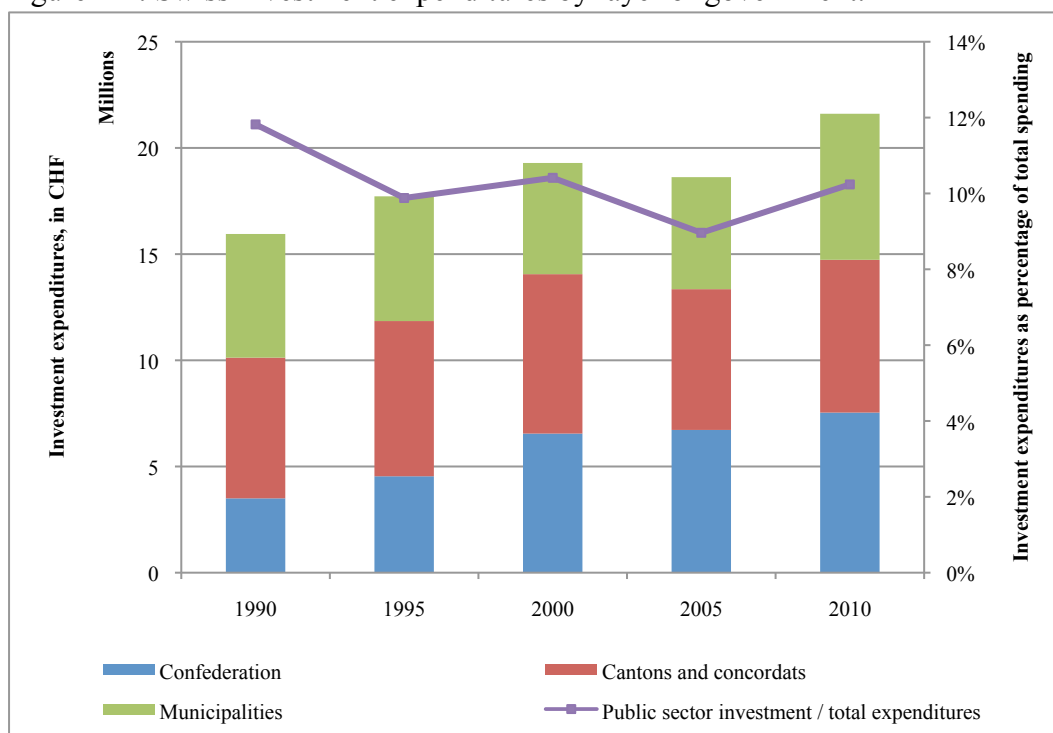
- Theoretically, decentralized levels of government can be modelled as small open economies.

- A strategic game occurs between these sub-central jurisdictions, leading consequently to strategic behaviours.

In fact, like a small open economy, a decentralized layer of government, if conducting an expansionary fiscal policy, would take the risk of seeing its resources spread between the neighbouring jurisdictions because of the potential spillover effect. The resulting strategy, which a rational jurisdiction is likely to adopt, is simply to wait on the action of the others, hoping to take advantage from the spillovers coming from their investment programmes.

However, as the stacked columns representing the investment expenditures of each Swiss layer of government in Figure 1-1 show, the volume of public investment is, at best, equally shared between the Confederation, the cantons and the municipalities. As a consequence, whereas the above-mentioned theoretical analysis would assign to central government the goal of maintaining the macroeconomic stability, it appears that, in reality, the macroeconomic fiscal tools are fairly shared with the decentralized levels of government. A similar analysis would most likely hold for a more centralized nation than Switzerland.

Figure 1-1: Swiss investment expenditures by layer of government.



Source: Author's elaboration from data presented in Appendix A.

In conclusion of this first theoretical chapter, we realize that, on the basis of the advantages and disadvantages related to fiscal discipline, taken in its large meaning, a jurisdiction benefits from a certain room for manoeuvre in its interpretation of the concept; the degree of discipline being subject to varying understandings and definitions. Although nor the optimal level of constraint, neither the exact sense of it, is determined, it seems however obvious that a certain control over fiscal policy is required.

## 2 The requirement of setting rules

As we learned from the discussion on its pros and cons exposed in the previous chapter, fiscal discipline may be interpreted in various ways and be subject to different degrees of severity. In fact, this debate did not elaborate much on the concrete economic sense to be given to fiscal discipline. As a matter of fact, fiscal discipline can be associated to several criteria of control according to how the concept is measured<sup>28</sup>. Concretely, the absence of a single definition allows governments and jurisdictions to enjoy a certain level of freedom in the meaning they attribute to fiscal discipline. Nevertheless, as pointed out by Novaresi (2001: 66), their choice should be explicit and their objective clearly formulated.

Having reached this stage, one theoretical issue remains to be discussed: the transposition, or not, of the chosen principle of fiscal discipline into *legally binding rules* and, in the extension, the potential effectiveness of such tools. Although this further step may seem redundant with Chapter 1 at first glance<sup>29</sup>, the question of using binding rules in order to achieve fiscal discipline, instead of simply announcing a given commitment, requires taking into account another line of reasoning, including mainly public choice considerations. Whereas we previously tackled essentially the question of the necessity of controlling fiscal deficits, the focus of the second debate takes thus place on the opportunity to transpose such target into legally binding rules. In other words, we intend to examine how a budget constraint written into the law is more credible and effective than an announcement of the same measure as a policy target.

Neglecting the content of such legal constraints, the concept of “fiscal rules” is for the moment considered in its broad sense and defined as an institutional modification of the environment framing the fiscal decision-making<sup>30</sup>. Thereby, the two following sections investigate only the theoretical justification for

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<sup>28</sup> Novaresi (2001: 42-65) presents and discusses the three major concepts of fiscal discipline: the golden rule of public finance, the fiscal sustainability and the structural balance. Regarding the golden rule, see also Dafflon (2010: 3-6).

<sup>29</sup> On the basis of the debate on fiscal discipline (Chapter 1), the partisans of fiscal discipline are indeed expected to defend the commitment to fiscal rules, while the opponents emphasise the uselessness of such constraints.

<sup>30</sup> The economic literature distinguishes several classes of fiscal rules, which are differentiated according to their specific nature. This matter is further developed in the next chapter.

adopting, or imposing<sup>31</sup>, fiscal rules in order to ensure the respect of the discipline, to which a jurisdiction is committed. To this end, we firstly expose the arguments stressing the virtue of setting rules, as well as the shortcomings related to the government non-binding commitments. Afterwards, we logically present the disadvantages and the risks linked to the implementation of fiscal rules.

## **2.1 Advantages of setting binding rules**

Why is a legally binding budget constraint more desirable than a simple announced commitment to fiscal discipline? The economic literature provides several answers to this question. We summarize here the main arguments intending to prove the advantages brought by the implementation of such legal restrictions. Whereas the two first groups of arguments highlight the existence of several mechanisms, which lead fiscal policy to deviate from discipline and justify to set rules, the three following ones emphasise more some advantages offered by such constraints.

### *2.1.1 Fiscal rules as a limit to deficit bias*

The first rationale for implementing fiscal rules takes its roots in the positive analysis of the democratic political institutions originally developed by the authors of the School of Public Choice. For them, the fiscal policy outcome does not result from the decision of a social-welfare-maximizing planner, but rather from a political process, which shows obvious *bias towards deficit* (Drazen, 2002: 5). Arguing indeed that, “in a democracy, political competition is not unlike market competition”, Buchanan and Wagner (1978: 87-88) consider that “politicians compete among themselves for the support of the electorate, and [that] they do so by offering policies and programs which they feel will get them elected or reelected”. Put differently, the hypothesis of opportunistic policymakers substitute the theoretical view, according to which governments are benevolent economic agents and thus deprived of self-interest. Hence, if the budgetary choices appear to be truly influenced by political variables, then an intervention at the institutional level, i.e. the implementation of binding rules, would serve as a

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<sup>31</sup> A jurisdiction can either adopt spontaneously and voluntarily a fiscal rule for itself or, be constrained by an upper level of government; for instance, the regional to the local, or the supranational to the national level as it is the case for the member states of the EMU.

constraint on policymakers and would contribute to reduce or, in the best case, eliminate the tendency towards budget deficits (Alesina and Perotti, 1995: 24). Buchanan and Wagner (2000 [1977]: 125) summarize the consequence of this political feature by arguing that the “budgets cannot be left adrift in the sea of democratic politics”.

Acknowledging this assumption about politicians’ behaviour, the economic theory distinguishes two main sources of deficit bias: the principal-agent relationship between voters (the principals) and the policymakers (the agents), and the so-called “common pool” problem of public finance. While the former phenomena is due to an asymmetry of information between the “contracting parties”, leaving policymakers the opportunity to extract rents, the latter issue “arises when politicians can spend money from a general tax fund on targeted public policies” (von Hagen, 2005: 2), which leads the group who benefits from them (and the politicians representing it) to increase their demand for such spending programmes. The occurrence of both situations puts thus into lights the incentives, which governments are facing, towards excessive levels of public expenditure and, *in fine*, towards public deficit. In this context, the implementation of budget constraints, consisting in reinforcing fiscal transparency and depoliticizing budgetary decisions, is expected to prevent such deviation in terms of fiscal policy outcome (Kopits, 2001: 8).

### *2.1.2 Occurrence of moral hazard*

In economics, moral hazard refers to the lack of incentive for economic agents to adopt responsible behaviour; this phenomena inducing an undesirable risk transfer from the “irresponsible” agent to another one. As far as fiscal discipline is concerned, the economic literature identifies two sources of moral hazard resulting from two different types of relationships. Moral hazard may indeed occur between the member states of a union<sup>32</sup>, as well as between the successive governments of a given jurisdiction. In the latter case, we speak of intertemporal moral hazard (Novaresi, 2001: 68).

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<sup>32</sup> It concerns both the relationships between the decentralized jurisdictions within a federal state, and between the autonomous member states of monetary union such as the European EMU.

As already mentioned in the Introduction, the participation in a monetary union, like the European EMU, may lead the member states to adopt opportunistic fiscal behaviour, which can be modelled as a typical “free rider” problem: although sustainable public finance is in the interest of the union as a whole, an individual member state may have the incentive to behave otherwise. This opportunistic behaviour is further strengthened by the link of solidarity implied in the participation in the monetary union. The several European rescue plans addressed to Greece, Spain, or Portugal during these last years, offers an obvious proof of the underlying solidarity among the EMU participants. In order to avoid such situations, constraining individual countries’ fiscal policy allows reducing this negative incentive, as well as limiting the risk of having recourse to this bond of solidarity between the member states.

However, as von Hagen and Eichengreen (1996: 134) did, it is interesting to note that fiscal restrictions are not prevailing in most monetary unions. Such legal clauses are indeed the exception rather than the rule<sup>33</sup>.

The other source of moral hazard comes from the intertemporality of fiscal policy. Here, the moral hazard problem occurs between the government in  $t$  and the one in  $t+1$ . Fiscal reforms being politically costly, the government in  $t$  does not have the incentive to undertake them but rather prefers to delay them (Drazen, 2002: 8). Moreover, this temporal link can be used by the current government in order to constraint their successor (Fatàs *et al.*, 2003: 28). The room for manoeuvre, in terms of fiscal policy, allocated to the future government would therefore be reduced. The public indebtedness, through its impact on the future policy choices due to the payment of the service of the debt, becomes potentially a useful tool allowing constraining the successive governments (Milesi-Ferretti, 1996: 3). Here again, the implementation of legally binding budget constraints, applicable independently of the time period, offers the advantage of limiting the intertemporal moral hazard phenomena and consequently, reduces the risk of delaying necessary fiscal reforms, as well as the impact of the government in  $t$  on the fiscal policy in  $t+1$ . More generally, Poterba (1996: 9) highlights that “if

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<sup>33</sup> Primarily based on this observation, the authors suggest that the European budget constraint is redundant.

society exhibits dynamically inconsistent preferences with respect to fiscal policy, always preferring a larger budget deficit in the current period than it would have been agreed to in previous, then budget rules may provide a mechanism for constraining the discretion of future budget deliberators.”

### *2.1.3 The threat of the sanction reinforces the budgetary pressure*

One major difference between a non-binding commitment and a legal restriction lies in the fact that a law provides penalties<sup>34</sup> (explicit cost) in case of non-compliance. Quoting Drazen (2002: 12), “laws enhance credibility to the extent that they *raise the cost* and *lower the benefit* from deviating from a given policy”. As a consequence, the temptation of deviating from the chosen fiscal path is reduced. In addition, such mechanism may also influence the budget deliberation through the pressure for budget compromise it puts on the decision makers (Poterba, 1996: 29); the latter risking politically painful sanctions in case of gridlock in the negotiations. The existence of legally binding rules is thus more likely to produce its targeted effect than the simple announcement of a given fiscal stance.

### *2.1.4 Rules provide a benchmark for budget deliberations*

Because it restrains fiscal illusion by making explicit the financial implication of any public spending decision, we argue in Section 1.1 that fiscal discipline contributes to facilitate the achievement of the optimal size of public sector. Similarly, transposing fiscal discipline into legally binding budget rules constitutes a further improvement in terms of budget deliberations. In fact, the implementation of a clear budget constraint provides a benchmark, making the assessment of any budget proposal easier. So, the fiscal rule serves as an objective standard, which clarifies the terms of fiscal policy debate (Poterba, 1996: 28-29); each proposal being evaluated according to its degree of compliance with the constraint.

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<sup>34</sup> The next chapter shows that it exists a wide range of possible sanctions, which have a varying impact on fiscal behaviour. For now, we do not distinguish the possible systems of penalties.



### 2.1.5 Reputation

Some economists advance one last argument defending the advantage gained by fiscal rules over announced commitments to discipline. This argument is related to the *signal* that such formal commitment represents and, more precisely the information it conveys (Drazen, 2002: 17).

Under incomplete information, policymakers' reputation depends on observed past actions. From this perspective, anything, which contributes to show the respect to the committed fiscal discipline, may strengthen the reputation. In this sense, the implementation of fiscal rules, by increasing the public's awareness of deviations from fiscal responsibility, more than constraining policymakers, provides a further signal of their commitment and preferences, makes them more credible, and therefore, improves their reputation<sup>35</sup>. Hence, the adoption of legally binding constraints has to be interpreted as one of those actions, which allow building a reputation of fiscal responsible government.

## 2.2 Disadvantages of setting binding rules

We turn now to the arguments questioning the necessity to translate the principle of fiscal discipline into formal legislation. We distinguish different types of reasons why some economists have expressed doubts about such legal constraints. For some, assuming the efficiency of credit market mechanisms, the adoption of rules is considered as useless. For others, the fixation of rigid restrictions would be counter-productive, since it encourages strategic behaviours, such as creative accounting, in order to circumvent the rule. Finally, the literature still mentions some difficulties linked to the implementation of fiscal rules, for instance when it comes to enforce the sanctions prescribed by the law.

### 2.2.1 The market discipline hypothesis

Unlike the arguments advanced by the School of Public Choice and preconizing the adoption of fiscal rules, their opponents believe in the capacity of the credit market mechanisms to frame the policymakers' fiscal decisions. The idea behind this argument relies on the efficiency of the credit market. According to this

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<sup>35</sup> For a more detailed insight on this issue, see for instance Drazen (2002: 17-19).

viewpoint, “default premia and credit constraints can play a more positive role in disciplining irresponsible, sovereign borrowers” (Bayoumi *et al.*, 1995: 1046). Acknowledging the so-called market discipline hypothesis, fiscal rules represent an unnecessary institutional instrument, which moreover imposes needless bureaucratic requirements (Kopits, 2001: 7).

Assuming that the four conditions described by Lane (1993: 53) are fulfilled, i.e. open capital market, perfect information on the borrower’s existing liabilities, no bailout opportunity, and coherent borrower’s behaviour with market signals<sup>36</sup>, the capital markets would be able to automatically regulate government borrowing. The lenders indeed adapt the interest rate charged according to the borrowers’ degree of solvency: the higher the sovereign indebtedness, the lower the solvency, and logically, the higher the interest rate. This mechanism would therefore provide a clear incentive to avoid excessive level of debts and serves as an automatic fiscal regulation.

However, the stringency, as well as the number, of assumptions implied in the market discipline hypothesis tends to invalidate, or at least weaken, the functioning of this market mechanism (Ter-Minassian and Craig, 1997: 163-164). Looking at the recent history of the Eurozone, Rossi and Dafflon (2012) further discredit the market discipline hypothesis by providing empirical evidence of its malfunctioning. Between 2000 and 2008, although the public finances of the EMU member states were taking different paths (significant variations in the evolutions of the public deficits and debts), the authors surprisingly observe that their respective long-term interest rates on sovereign debt do not reveal such diverging evolutions. It appears thus that the market discipline mechanism did not work.

### *2.2.2 Rules induce nontransparent behaviours*

Whereas their partisans see in the adoption of legal rules the best channel allowing limiting the fiscal illusion and the deficit bias related to fiscal policies, numerous authors emphasise the several undesirable incentives due to the

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<sup>36</sup> In his paper, Lane (1993) lists the necessary conditions, under which the market discipline hypothesis is valid, and explores their implications.

implementation of a budget constraint. Indeed, this second argument, questioning the potential effectiveness of binding fiscal restraints, points out the political behaviours that such constraints are likely to produce. As a consequence, some economists consider that, instead of insuring the politicians' fiscal responsibility, fiscal rules enhance the temptation to adopt opportunistic behaviour, and may thus produce the opposite effect.

In fact, the reasoning behind this scepticism does not specifically concern fiscal rules but, more largely, any "rules-based" approach. As acknowledged even by the strongest supporters of the legally binding constraints, "any rule (law, constraint), once put in place, will necessarily provide incentives for violation, either openly or covertly" (Buchanan, 1997: 130). In other words, this statement means that, instead of constraining the behaviour of the economic agents who are subject to the restriction, the rules, by their nature, favour the adoption of various strategies allowing circumventing them. Generally speaking, this kind of behaviours is associated with a reduction of transparency in the manner of achieving the legal requirements. Fiscal rules are no exception to this phenomenon and, as far they are concerned, budgetary transparency is at the core of the issue (Forte, 2001: 258). Consequently, the question of the compliance with the fiscal rule involves on the one hand the general degree of transparency of the public budget and, on the other hand, the methods through which policymakers are able to elude the budget constraint; the latter being usually referred as the "creative accounting" practices<sup>37</sup>.

As we saw before when exposing the general debate on fiscal discipline and more precisely the modality of resource transfer from the private to the public sector (Section 1.1), the lack of transparency, either in the fiscal choices or in the budgetary process, can give rise to voter's confusion (fiscal illusion). Because it grants governments a strategic advantage, this ambiguity weakens the

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<sup>37</sup> In their empirical study testing the hypothesis, according to which European governments use creative accounting methods in order to circumvent fiscal rules, von Hagen and Wolff (2006) find significant evidences confirming the link between fiscal restrictions and nontransparent accounting behaviours.

policymakers' incentive to be fiscally responsible<sup>38</sup>. Similarly, with the implementation of a legally binding constraint – for instance a rule fixing a given numerical fiscal target – politicians are encouraged to develop suitable accounting methods, designed to show an apparent compliance with the law, although the fiscal target is in reality not reached (Kopits, 2001: 7; Drazen, 2002: 13). For example, when facing a deficit ceiling, a government could “cook its books” through a reclassification of its current spending in capital spending. Regarding a debt limitation, keeping public activities or items “out” of the public sector budget would easily “hide” part of public indebtedness. Such cosmetic accounting tricks<sup>39</sup> indeed modify the official fiscal figures, although they do not improve, nor change, the real public fiscal position.

Acknowledging the existence and the regular use of such nontransparent accounting behaviours<sup>40</sup>, several economists, like Milesi-Ferretti (1996: 2) or Ter-Minassian and Craig (1997: 166-167), emphasise the relevance for fiscal rules to be firstly, supported by clearly defined accounting standards and secondly, directly addressed to the above-mentioned negative incentives. Meanwhile, to be effective, fiscal constraints have still to be sufficiently simple in order to minimize the risk of opportunistic interpretations. As highlighted by Alesina and Perotti (1999: 27), “complicated rules and regulations provide fertile ground for nontransparent budget procedures”.

In conclusion, we easily understand the great importance of the issue of creative accounting and the necessity to provide adequate answers to it; the risk being to end up with unenforced and thus useless fiscal rules. Surprisingly, the economic literature remains relatively discrete and unconvincing when it comes to find solutions to these accounting tricks<sup>41</sup>. However, Novaresi (2001: 73) recently

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<sup>38</sup> On the basis of this theoretical development, Alesina and Perotti (1999: 25) further point out that “politicians have little incentive to produce simple, clear and transparent budgets”. For these authors, the high complexity of the budgets of modern economies is only partly due to intricate policy programs. Indeed, this characteristic of public budgets seems rather uncalled-for and serves more policymakers' agenda.

<sup>39</sup> For other examples, see Schultze (1995: 326) or Ter-Minassian and Craig (1996: 166).

<sup>40</sup> Dafflon and Rossi (1999) provide, for instance, a survey of the accounting fudges, which have been used by the candidate countries for the EMU at the qualifying stage.

<sup>41</sup> Buchanan (1997: 130) simply admits that “no law could pass perfect enforcement” but argue that it does not necessarily imply that it would fail in imposing a certain degree of constraint.

mentioned a more persuasive argument, which defends that creative accounting methods are no fatality. Observing that accounting fudges are possible as far as the institutional framework allows them, a sound adaptation of the latter could certainly bound such nontransparent behaviours<sup>42</sup>.

### 2.2.3 Risky reliance on forecasts

Looking at the usual fiscal rules in force nowadays, some economists realized that their definitions and functioning rely, under several aspects, on forecasts. Typically, the fiscal rules built on a *budget* constraint, which consists in balancing the total outlays with the total receipts, concern, by definition, the forecasted outlays and forecasted receipts. Logically, the estimations of these aggregates require making a forecast about the future economic performance. Unfortunately, such exercise is not without implying risks.

Firstly, like any forecast, the expected fiscal revenues, as well as the expected public spending, contain a certain degree of uncertainty. Secondly, it is far from sure that different forecasters would perfectly agree on their respective estimations. When facing a variety of diverging forecasts, how would the policymakers decide the relevant base, on which the budget is defined? Obviously, in order to easily respect the budget constraint, the governments would have the incentive of opting for the forecasts overestimating future public revenues and underestimating future public expenditures (Rosen and Gayer, 2010: 132). The *ex ante* budget rule, based on forecasts, could then be satisfied, without really caring about the *ex post* compliance. More dangerous than the inherent risk of making forecasts under uncertainty, such *ex ante* rules may induce speculation. The questionable growth forecasts, on which the countries base their expected spending and revenues, represent the typical example, in which the borderline between uncertainty and speculation is regularly crossed.

However, as we further develop later, the issue of the reliance on forecasts may be efficiently addressed if the rules are designed so as to enforce sanctions on the account, rather than on the budget figures. In this case, under-assessments of

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<sup>42</sup> The update of the European system of accounts 1979 (ESA 79) to the ESA 95 goes to that direction.

spending and/or over-optimistic estimations of revenues do not allow escaping the penalties since the latter are decided according to the realized, and not the estimated, fiscal figures.

#### *2.2.4 Unenforceability of sanctions*

Although the partisans of fiscal rules consider that the existence of penalty mechanisms constitutes an improvement over announced fiscal commitments (Subsection 2.1.1), the opponents underscore, on the contrary, the lack of efficiency related to such sanctions. Based on the US, as well as the European experiences, the latter authors indeed point out how rarely these measures, though provided in the law, were taken. For the US case, Rosen and Gayer (2010: 132) confirmed this statement by noticing that, as far the Congressional spending caps was concerned, “when the consequences of complying with the law seemed worse than ignoring the law, the law was ignored”.

As a strong partisan of fiscal regulations, Buchanan rejects this argument. He indeed considers that the danger to abandon sanctions can easily be avoided with the enforcement of “automatic triggers”, which would enter into force independently of any decision-making (Tempelman, 2007: 446). Concretely, it would mean that, once the threshold provided in the rule is exceeded, correction measures, like tax increases or expenditure cuts, would automatically be implemented.

#### *2.2.5 Rules reduce fiscal flexibility*

As we saw in the last chapter, some authors, inspired by the Keynesian approach, consider fiscal policy as an instrument of macroeconomic stabilisation. From this perspective, the adoption of strict rules would logically constitute a restriction in the fiscal flexibility of policymakers, and therefore, in their ability to restore macroeconomic equilibrium when required.

Noticing that past experiences showed the limit of this hypothesis (especially through the empirical evidences for the deficit bias), Buchanan (1997: 129) simply responds to this argument by emphasising that reducing politician’s flexibility is precisely the point of such budget rules.

### **3 Definition and role of fiscal institutions**

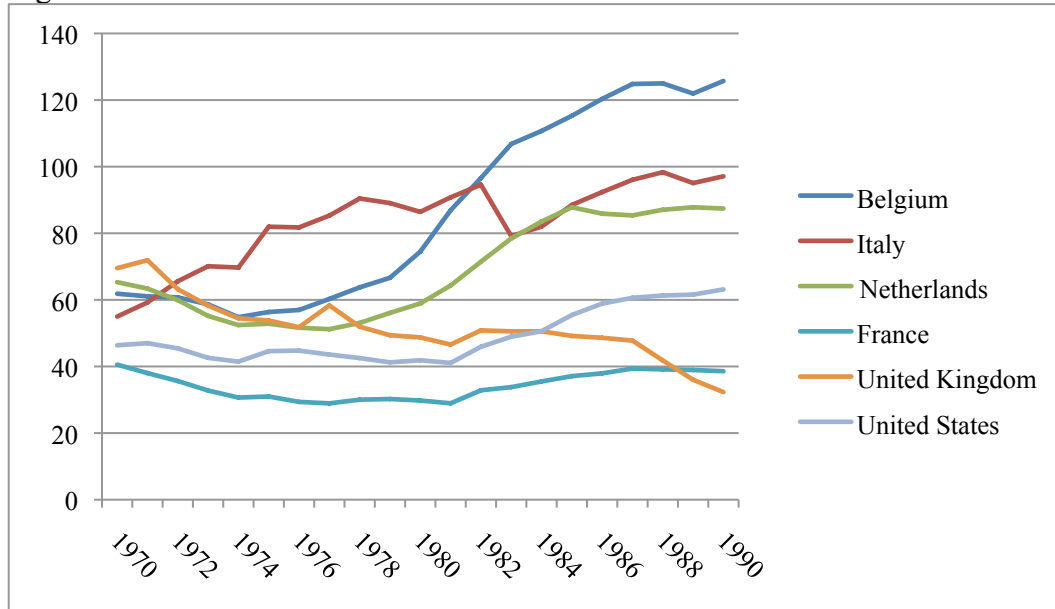
After having exposed, on the one hand, the debate on fiscal discipline (Chapter 1) and, on the other hand, the ins and outs of the implementation of legally binding fiscal rules, optimally ensuring fiscal responsibility (Chapter 2), the third and last theoretical chapter takes a deeper look at the meaning and the content of the term “fiscal institutions”. Before describing and analysing the institutional design of the European fiscal regulation in Part II, it is indeed not pointless to define more precisely the concept of “budget rules”, to which we have referred in its broad sense until now.

As we emphasised in the Introduction, the economic research showed for long little consideration in the study of institutions and the way they could potentially affect agents’ behaviour as well as policy outcomes. In fact, they were viewed as simple “veils” with minor influence on economic activities. Naturally, many public finance economists have also followed this general trend and neglected thus the role of fiscal institutions.

However, simultaneously to the general regain of interest in the late 1980s for institutional economics (Chavance, 2007: 4-5), a recent observation on historical fiscal outcomes triggered scholars’ attention. Looking at the evolution of fiscal stance across nations, a new and significant tendency is noticeable (Figure 3-1). We perceive indeed clear differences in the size and the persistence of budget deficits among OECD countries. Although these nations record a relatively similar level of economic development, their tracks of indebtedness vary; some of them taking a rising path (in the graph: Belgium, Italy, Netherlands), whereas the stock of debts of some others staying relatively stable through time (France, United Kingdom, United States). Since this unprecedented phenomenon mainly concerned relatively similar countries in terms of their economic development, some researchers, such as Alesina and Perotti (1995: 2-3), concluded that economic variables alone could not explain these differences. Searching for other parameters that would potentially clarify these diverging fiscal paths, they decided to investigate further the role of institutions (electoral rules, party structure,

budget laws, degree of decentralization, political stability, etc.), which, contrary to the OECD economic features, tend to vary across the concerned countries.

Figure 3-1: Debt-to-GDP ratios of some OECD member states.



Source: Author's elaboration from data of OECD (2012).

Historically, the concept of “institution” has been interpreted according to various definitions provided by different schools of thought. Depending on the periods, institutions have been successively portrayed as collectively decided formal organizations, as informal rules and orders (language, moral, culture, etc.), or still as the “rules of the game” formally and informally constraining economic agents’ actions<sup>43</sup>. With the emergence in the 1990s of the so-called new institutional economics, the literature has reached a certain consensus about the sense to be given to this notion (Chavance, 2007: 59). North (1991: 97), one of the most prominent authors of this movement, defines thus the institutions as “the humanly devised constraints that structure political, economic and social interaction [and] consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)”. The wide range of facets contained in this definition not only reflects the complexity of the institutional analysis, but also suggests that the economic issues can be analysed under multiple institutional levels.

<sup>43</sup> For a complete and clear synthesis of the different institutional approaches, see Chavance (2007: 104-105).



Of course, this conceptual difficulty is similarly present in fiscal matters and constitutes an important inconvenience for the economic research since the term “fiscal institution” can refer to numerous institutions of different nature. For instance, a quick review of the literature, which investigates the link between institutional aspects of fiscal policy and the evolution of the public sector fiscal stance, demonstrates obviously the absence of a clear-cut agreement on the concrete definition to be given to the term “fiscal institution”, as well as the certain ambiguity when dealing with this notion. Despite that two studies may speak about “budget rules”, it is indeed not guaranteed that both refer to the exact same fiscal institution. Moreover, Poterba (1996:4) confirms that “the wide variation in budget rules makes it difficult to draw any uniform conclusions about the effect of such rules on policy outcomes”. Consequently, in order to clarify this notion and avoid any possible confusion, we proceed to the following classification of the institutions expected to influence fiscal policy. On the basis of the economic literature, we distinguish thus (1) the different electoral rules, (2) the budgetary institutions (or procedural rules) and finally, (3) the fiscal rules (also referred as numerical fiscal targets). Although some authors, such as Alesina and Perotti (1999: 15), Drazen (2002: 1), or Novaresi (2001:3), proceed to other classifications, which generally make a distinction only between the regulations governing the successive stages of budget process and the rules providing limits on fiscal variables. For the sake of completeness, we opt for considering the electoral institutions as well. The three first sections of the present chapter survey each of these classes and provide some theoretical insights about their link with fiscal policy outcomes.

Finally, given the above-mentioned definition of the term “institution” provided by North and, looking at the institutional Swiss environment, it must be noted that this country presents a quite unique particularity by specifying the popular initiative and referendum rights at each level of government<sup>44</sup>. Since these democratic instruments imply that all political decisions may potentially be subject to voters’ agreement, they constitute a strengthening of the popular control

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<sup>44</sup> Although each canton and municipality provides such rights, the concrete arrangements and modalities of implementation may however differ across the latters.

over the jurisdictions and their politicians, which obviously influence their behaviour and, potentially, the fiscal policy outcomes. Therefore, the last section exposes briefly the concrete scope of this control competency, as well as its expected impact on fiscal policy.

### 3.1 Electoral rules

Although the rules framing political competition are usually referred as “electoral institutions” instead of “fiscal institutions”, the economic literature, dealing with fiscal policy issues, regularly points out the underlying link between the electoral systems and the public sector fiscal situation. Without leading directly the budget process or the definition of numerical fiscal targets, it appears indeed that the characteristics of electoral rules may indeed influence spending decisions and, in the extension of that, the risk of running deficits. For this reason, we deem relevant to explain briefly this relationship and its implications for the achievement of fiscal discipline.

To begin with, what do electoral systems mean? According to Blais (1988: 100), who basically rephrases the definition provided by Douglas Rae in his seminal book<sup>45</sup>, “electoral systems are defined as those rules which govern the process by which preferences are articulated as votes and by which these votes are translated into the election of decision-makers”. This definition implies the existence of various way of reaching this fundamental objective, namely translating votes into seats. Whereas the classification of the different existing electoral systems has not get to any strong and stable consensus among authors<sup>46</sup>, the latters however agree on the three essential criteria, which allow an appropriate characterization of the existing systems. These are (1) the ballot structure, (2) the constituency structure and (3) the formula. Without entering into greater details, let us simply assume that the ballot structure concerns the object of the vote (voting for individuals *versus* voting for a party-list), the constituency structure refers to the district magnitude (the number of seats allocated to each district) and finally the formula defines the rule, according to which the votes are translated into seats (plurality

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<sup>45</sup> In the field of comparative electoral systems, Rae’s contribution, entitled “The Political Consequences of Electoral Laws” and published in 1967, was a resounding scholar success, which marked a breakthrough in this research area (Lijphart, 1990: 481).

<sup>46</sup> For a detailed discussion on the classification issue, see Blais (1988).

*versus* proportionality). From a public finance viewpoint, the different possible combinations of these characteristics may have an important impact on the types of fiscal policies that the governments implement and, more generally on politicians' fiscal behaviour. The theory of political economy considers that this influence can be expressed through two channels.

The electoral framework can firstly modify the degree of political competition and accountability. Thereby, given the hypothesis stating that "voters use elections to hold politicians accountable for past performance" (von Hagen, 2005: 4) – the so-called retrospective-voting paradigm – the electoral system influences directly politicians' behaviour. As far as fiscal policy is concerned, if the voters are perfectly informed (strict political accountability) and have to choose between numerous candidates (strong competition), then, the incumbents, who seek to be re-elected, face little incentive to extract rents while being in office. Consequently, this suggests that, under these conditions, fiscal discipline is more likely to be respected. Looking now back at the above-mentioned criteria, which characterize electoral systems, we easily understand that a candidate ballot, in a small district in terms of seats, governed by the plurality rule (also called "winner-takes-all") would maximize personal accountability at the expense of a weaker political competition (because of the higher entrance barrier for challengers due to the necessity of getting the majority of the votes). On the opposite, a party list system, implemented with a large district magnitude, and a proportional representation would make personal accountability less clear but strengthen political competition (von Hagen, 2005: 5).

Inspired by the same central hypothesis, Milesi-Ferretti *et al.* (2002: 610) demonstrate that the electoral rules have also an influence in the nature of public spending favoured by politicians in office. The idea is the following: if, for the voters, the elections can serve as a way to sanction incumbent's behaviours, they may also operate in order to reward the politicians with preferences for government spending decisions going in the direction of the electorate. Therefore, politicians may maximize differently their re-election chances according to the electoral formula. For instance, in a majoritarian system (each constituency elects one deputy), representatives would logically be more prone to provide local

public goods, which benefit mostly their district. In contrast, in a proportional system (more than one deputy per constituency), political parties, who represent different social groups equally distributed across the whole country, would prefer government spending on transfers to expenditures on public goods.

On the basis of this first theoretical transmission channel, von Hagen (2005: 5) considers that there are two main implications to be learned for the study of public finances. On the one part, electoral systems can reinforce representatives' accountability, which should allow minimizing public spending. On the other part, the nature of government expenditure programmes also depends on the electoral rules into force. For instance, "proportional representation should lead to higher shares of broad-based welfare programs and general public goods in public spending than plurality rule".

Apart from the influence of electoral institutions on the size and the nature of public expenditures, Hallerberg and von Hagen (1997) find empirical evidences suggesting the existence of a second impact of electoral systems. This time, the electoral institutional framework matters because of the effect it has on the type of budgetary institutions that a government has at its disposal, which is due to the kind of government in place; namely a one-party government (common outcome under a plurality system) or a multi-party government (proportional representation). While, in the former case, the formulation of the budget requires the approval of a strong finance minister, in the latter one, fiscal targets are negotiated among parties, making the monitoring at this stage more difficult and, *in fine*, the existence of greater fiscal deficit more likely.

### **3.2 Budgetary institutions**

"Without any restrictions on procedures, without any structure and rules, Arrow's impossibility theorem implies that a legislature would never produce a budget but only legislative chaos" (Alesina and Perotti, 1999: 17-18). Since they are defined as "all the rules and regulations according to which budgets are drafted, approved, and implemented" (Alesina and Perotti, 1995: 21), budgetary institutions may thus provide an adequate answer to the well-known Arrow's theorem. Moreover, this definition suggests the succession of, at least three relevant phases in the

budget process: (1) the formulation of a budget proposal, (2) its approval, and finally (3) its concrete implementation. Note that some authors add a fourth step, which consists in the ex-post accountability phase<sup>47</sup>. Leaving aside the latter, in the present section, we concentrate our attention on the three main stages and more precisely on the different actors they successively involve. Given the significant differences in the way budget are drafted, discussed, approved and finally implemented (Poterba, 1996: 44), we try to highlight the fundamental features governing these three steps<sup>48</sup>. All together, these procedural rules, by which fiscal decisions are made and executed, form the budgetary institutions.

### 3.2.1 *The formulation*

In this first stage of the budget process, the executive branch of government is in charge of the formulation of budget proposal. In order to complete this specific task, a consensus has to be reached among the members of the executive, who may defend opposite interests. This political exercise can be modelled as a bargaining between two main categories of agents: on one hand, the prime minister and/or the finance minister and, on the other hand, the so-called “spending” ministers. While the latter try to maximize the share of global budget, which will be allocated to their department and let at their disposal, the prime minister and the finance minister, being more prone to take into account the costs of the additional expenditures, in terms of taxation, tend to be more fiscally responsible (Milesi-Ferretti, 1996: 8-9). In consequence, depending on who benefits from a dominant position, the negotiation could tip the scales in favour of more or less fiscal discipline.

Looking at what determines these strategic interactions and, more fundamentally, gives the advantage in the bargaining, von Hagen (2005: 6), among other authors, points out the relevance of the *degree of centralization* in the decision-making process. He indeed argues that a more centralized budget process provides a dominant role to the finance minister, whereas a more fragmented or “collegial” process favours the interests of the spending ministers, which induces a deficit bias. More generally, Alesina and Perotti (1995: 26) consider that “procedures

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<sup>47</sup> See, for instance, von Hagen (2005: 7).

<sup>48</sup> For further explanations about these three stages, see Milesi-Ferretti (1996: 7-17).

that make a Prime Minister [or a finance minister] strong are those that limit the veto power of spending ministers” are more likely to counter the deficit bias.

### *3.2.2 The approval*

Once the draft budget being formulated by the executive, it has still to be approved by the legislative. At this stage, Milesi-Ferretti (1996: 12) enhances two fundamental aspects, which may potentially affect the final fiscal outcome towards reinforcement or, on the contrary, towards the relaxation of discipline.

Firstly, the author points out that, according to the institutional framework, the scope of the legislative amendments can vary significantly, which induces different behaviours among members of the parliament (MPs). Similarly to the previously mentioned spending ministers within the executive for their department, it is in the interest of the MPs to favour policy programmes targeted to their constituency. Therefore, if the MPs can add new expenditures to, or cut revenue sources from the budget proposal, they would most likely fight, through amendments, for some adjustments of the budget benefiting their constituency. In order to ensure fiscal discipline, a limitation of the scope of amendments seems required.

The second aspect mentioned by the Italian economist deals with the strategic relation between the government and the parliament when it comes to concretely approve the proposal formulated by the former. Here, two phenomena are conceivable. Firstly, the executive may design its budget plan, so that its likelihood of being approved by the legislative is high. In this case, the fiscal outcome strongly depends on the existence of a deficit bias at the parliament level. Additionally, the affiliation of the MPs may also play a role in the support of the draft budget. As a matter of fact, MPs representing the party(ies) being in office at the executive branch would certainly accept the proposal and, by doing so, offer a relative dominant position to the government in the negotiation process. Note that this mechanism is especially important since the theoretical literature usually consider that “institutional arrangements that favour the executive in conflicts arising with the parliament are considered more conducive to fiscal discipline” (Fabrizio and Mody, 2006: 701).

Related to the latter issue, the voting procedure at the parliament stage can also contribute to limit budget deficit. For instance, a sequence of vote, which imposes first to discussion on the overall size of the spending and then a debate on its particular content, has serious chances to lead to more fiscal responsibility (Alesina and Perotti, 1995: 26).

### *3.2.3 The implementation*

After having reached an agreement on a budget law, the next and ultimate step consists in its actual implementation. As far as fiscal discipline is concerned, the role of budgetary institutions, during this final phase, resides in safeguarding the adequate application of the fiscal choices formulated by the government and approved by the parliament. In other words, the key issue here lies in the degree of strictness in the realisation of the budget law. Complementary to the question of how binding is the budget plan, the design of the processes of adjustments to unanticipated overspendings or overestimated fiscal revenues does also play a central role and constitutes the second important aspect of the implementation stage (Fabrizio and Mody, 2006: 702).

Regarding the degree of commitment to the budgeted spending, the relevant institutional characteristic dwells on the modalities required to diverge from the budgeted expenditures, as well as on the propensity of using such tools. We can indeed imagine different and variously restrictive rules regulating the process for adopting *ex post* budgetary modifications, going from the requirement of the simple approval of the finance minister to the necessity of providing a legal basis for any substantive budget revision. The more binding the initial budget law, the harder the budget constraint on spending centers and, consequently, the more credible the commitment to fiscal discipline.

In the same line of thought, a limitation in the ability of spending ministers to modify the budget during the fiscal year, to redefine the distribution of resources between the different budget chapters or even, to constitute budget reserve for forthcoming years, clearly contribute to reinforce fiscal discipline. Moreover, it is important to underscore that, without such restriction, not only the success of the budget implementation would be jeopardized, but the relevance of the preceding

budgetary phases would also be weakened, since they do not imply strict fiscal commitments (Milesi-Ferretti, 1996: 15).

### 3.3 Fiscal rules

Last but not least, fiscal institutions thirdly include the so-called “numerical constraints”, also referred as “legislative quantitative fiscal limits”. Generally speaking, this final group of fiscal institutions can be defined as all “the laws that prescribe numerical targets on the budget” (Alesina and Perotti, 1999: 15), which therefore suggests that this kind of constraints can be imposed on different budgetary aggregates according to different modalities. For instance, the Eurozone member states opted for public debt and deficit ceilings, whereas many states of the US and provinces in Canada set limits on the growth of taxes and public expenditures (von Hagen, 2005: 3). Since we already raised most of the theoretical issues regarding the utility (prevent the risk of bailout in a monetary union and enhance the control over public spending and taxation), as well as the danger (circumvent the authorized ceiling) related to the implementation of constitutional fiscal rules in the previous chapter, let us just introduce some practical concerns, against which we will come up in the second part.

Besides picking one or another fiscal aggregate, the setting of numerical constraints requires indeed operating several choices of definition and answering the following questions: How is the boarder of the public sector defined? Has the rule to be considered *ex ante* (at the phase of the budget formulation) or *ex post* (at the end of the fiscal year)? Although these issues may not seem complicated to solve, they nonetheless involve significant implications in government fiscal behaviour and further, in the stance of public finances. As we show in the next chapter, the “coverage” of the fiscal rule, as well as its sequence of implementation, seriously counts when it comes to assess the degree of fiscal discipline a given institutional framework leads to. These concerns are more precisely addressed later, when assessing the European budget constraint.

Another issue, which is worth to highlight, concerns the difficult debate on the exogeneity of fiscal institutions and of fiscal rules, more specifically. Although empirical evidence shows a correlation between the stringency of fiscal rules and



fiscal outcomes, some economists have challenged the interpretation of this observation. Assuming that the actual design of fiscal rules is the result of voters' and/or politicians' preferences, it would be then possible to consider that, rather than formal fiscal rules, preferences of the society constitute, ultimately, the main factor explaining fiscal policy outcome. This alternative viewpoint implies thus a shift from the approach of fiscal discipline to fiscal responsibility and, as a consequence, leads to the question of which of these two approaches comes first. In other words, if strict fiscal rules are more likely to be implemented in "debt-averse" jurisdictions, we could conclude that fiscal discipline is due to fiscal responsibility, which is the original determinant of fiscal outcome. If so, the empirical studies, tending to confirm the link between the fiscal constraints and fiscal performance, could, in reality, reflect the impact of the voters' preferences alone, or eventually combined with the institutional environment<sup>49</sup>. However, the complicated task of building an accurate index of fiscal preferences makes the investigation in this field of research difficult and any clear-cut answer uncertain. Nevertheless, as pointed out by Dafflon and Pujol (2001: 56-57), a better understanding of fiscal preferences could help grasping more precisely the specific effect of fiscal institutions, as well as explaining the outcome differences of similar fiscal constraints, in different jurisdictions.

### 3.4 The Swiss special case

As a final section of this third theoretical chapter, we wish to briefly describe the specificities of the institutional environment of Switzerland. Besides the above-mentioned institutions, the democratic framework of this country provides supplementary institutions that constitute further mechanisms constraining fiscal policy decisions. For this reason, Switzerland may be considered as a special case, in terms of its institutional settings.

In the so-called Swiss *direct democracy* system, citizens enjoy a great level of participation in the political, as well as economic, decision-making process. In

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<sup>49</sup> Using an index of regional fiscal conservatism as a measure of the Swiss citizens' fiscal preferences, Dafflon and Pujol (2001) find out that the latter has indeed an impact on the stance of the public finances. The calculation of their index being dependant on the democratic Swiss framework, their study could not be replicated in other contexts.

addition to the right to elect their representatives at each layer of government<sup>50</sup>, the Swiss voters can directly express their preferences through two further democratic instruments, which again exist in all central, regional and local jurisdictions: the *referendums* and the *popular initiatives*.

The right of referendum consists in the approbation (or not), through a popular vote, of legislative or constitutional acts. The referendum may be mandatory or optional according to the type of acts it concerns. At the central level, the amendments to the Federal Constitution, the accession to organizations for collective security or to supranational communities and some emergency federal acts *must* be subject to voters' approval (Art. 140 Swiss Cst.). For other federal acts or certain international treaties, a referendum *can* be organized if at least 50'000 citizens or eight cantons require it (Art. 141 Swiss Cst). Most of the 26 cantonal constitutions also make the distinction between mandatory and optional referendums. The criteria however differ from one region to the other<sup>51</sup>. For instance, in the canton of Fribourg, the referendum is compulsory for any constitutional modification and for any public expenditure decision superior to 1 per cent of the total functional spending of the preceding fiscal year. Optional referendums, concerning new laws or public expenditure decisions superior to ¼ per cent of the total functional spending of the preceding fiscal year, may take place at the demand of either 6'000 citizens (Art. 46 Fribourg Cst.) or ¼ of the regional deputies (Art. 99 Fribourg Cst.).

The second democratic mechanism, the popular initiative, offers the opportunity to the citizens to propose constitutional or legislative modifications, which are then subject to voter's approval. At the federal level, a constitutional initiative requires 100'000 signatures (Art. 138 Swiss Cst.); at regional level, such regulations also exist but vary widely. In the case of Fribourg, 6'000 signatures are necessary in order to propose any constitutional change or the "adoption, modification or abrogation of a law" (Art. 41 Fribourg Cst.).

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<sup>50</sup> The central government executive power, the Federal Council, is an exception to the rule. Its seven members are elected by the United Federal Assembly (the National Council together with the Council of States).

<sup>51</sup> Novaresi (2001: 147) provides a complete synthesis of each cantonal definition of the rights of referendum.

Generally speaking, these additional democratic mechanisms imply that almost all public decisions may be subject to popular vote and reinforce the control competency of the citizens, which, consequently, has a direct impact on fiscal policy decision-making. In fact, the referendum and initiative system not only improves the popular control over budgets, but also limits the potential rent-seeking behaviours of politicians or bureaucrats (Dafflon, 2007: 125). Moreover, in the budgetary process (Section 3.2), the existence of such democratic instruments, especially the referendum, can be used as a threat. Indeed, both in the formulation and approval phases, the members of the government and of the parliament have to take carefully into account voter's preferences because, in case of disagreement, they may have to face the popular sanction through the organisation of a referendum. For instance, this threat of referendum constitutes a powerful instrument in order to limit the propensity of the public sector to growth.

Finally, the Swiss direct democracy has an influence not only on the behaviour of its political elite, but also on the one of its citizens/taxpayers. Because voters are free to accept or reject the implementation of new public services, they are brought to weight their pros and cons. Concretely, they simply compare the estimated financial cost of a public project, i.e. the additional taxes, with the expected benefit. This link between the spending decision and the taxpayers logically favours the responsibility of those. Furthermore, this argument confirms the idea developed in the previous subsection, according to which fiscal institutions are designed by voters' fiscal preferences.

## **PART II: The institutional design of the European budget constraint**

The second part constitutes the heart of this Master's Thesis. After having, on one hand, clarified the theoretical debate on fiscal discipline, as well as on the issue of setting legally binding rules and, on the other hand, defined the relevant fiscal institutions, we come now to the detailed description of the institutional design of the Maastricht fiscal criteria and, to the extent, to its assessment. In order to reach this target, the following part is divided into three main chapters.

As a start, we need to specify the analytical grid that we use to estimate the effectiveness of the rules set in the Maastricht Treaty and reaffirmed in the more recent Stability and Growth Pact (SGP) and its successive amendments. Because “fiscal discipline is not a simple question of having or not rules limiting deficits and debt” (Dafflon, 2010: 2), we must define sharper criteria allowing to determine precisely the degree of fiscal discipline involved by any given budget constraint. Based on the elements learned in the preceding theoretical discussion, we try to highlight the several crucial elements, which an optimal fiscal rule should contain. *In fine*, this exercise leads us to present an assessment method, based on a sequence of questions, which successively address the key issues. First developed by Dafflon (1996: 240-243), this method has been implemented in different contexts and used mainly with comparative purpose<sup>52</sup>. Nevertheless, when applied to any single case, it offers not only a global critical view on the potential effectiveness of any fiscal rule but, it also points out the main features, which a budget constraint should contain in order to bring a concrete improvement in terms of fiscal policy. For this reason, it constitutes a helpful analytical framework for our study.

We focus then more precisely on the Maastricht criteria, to which the Eurozone member states – and for a part of the requirements, all EU members – commit themselves. The target is here to provide a detailed description of their

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<sup>52</sup> Novaresi (2001) studied and compared the fiscal discipline of the Swiss cantons. Dafflon (2002) used it for a comparison at the local level in ten European countries (9 EU member states + Switzerland). Later, Swianiewicz (2004) did the same for seven countries of the former Eastern Europe.

institutional design. Starting from the several law articles, concerning the European budget constraint and initially mentioned in the Treaty on the European Union (TEU, or the so-called Maastricht Treaty) and the Protocol on the excessive deficit procedure, annexed to this same Treaty, we will successively review all the relevant legal sources including the European System of National and Regional Accounts (ESA 95) and the different Council Regulations, which have influenced, and ultimately shaped, the institutional environment of the budget criteria over the time. This exercise helps us to clarify some central issues, such as the measurement of the deficit, the definition of the public sector, or the sanction mechanism, which all have significant policy implications (Blejer and Cheasty, 1991: 1675).

Finally, the last chapter of Part II is dedicated to the review and the assessment of the European budget constraint in force nowadays. It analyses the description exposed in Chapter 5 in the light of the method explained at the beginning of this second part. From our standpoint, this way of proceeding offers two main advantages. Firstly, through the essential properties of any fiscal rule developed along Chapter 4, we are able to evaluate, on the basis of a clear analytical grid, the strictness of the European instrument of fiscal discipline. Secondly, the method helps to highlight the weaknesses implied in the architecture of the rules and, consequently, the eventual contra-incentives they may create or the opportunistic behaviours they tend to favour.

## **4 From soft to hard budget constraint**

The primary purpose of the present Master's Thesis lies in the assessment of the European budget constraint. In order to reach our target, it is useful to begin with a description of the analytical framework, which allows us to determine the strictness of the Maastricht criteria. In other words, we wish to establish the relevant criteria that makes a budget constraint “soft” or “hard”, i.e. more or less efficient and enforceable.

Concretely, we need first to identify the fundamental aspects, which render a fiscal rule, so to say, “optimal”. Moreover, since the effectiveness of a budget constraint depends on several parameters, the exercise does not only require an individual analysis of those, but ultimately an overall assessment of the institutional framework as a whole. The presentation of Dafflon's methodology goes thus in that direction. Based on a sequence of questions that successively tackle the different aspects and components of such institutional arrangement, such as the content of the constrained fiscal aggregates, the time allowed to meet the criteria, or even the nature of the potential sanctions, the method aims at providing an overview of the quality of the concerned fiscal rule.

Before specifying our “analytical benchmark” and ultimately describing our assessment grid, next section clarifies some central fiscal concepts, which may have a significant influence on the outcome produced by any fiscal restriction. For instance, we investigate the notions of deficit and debt from an accounting perspective.

### **4.1 Some relevant fiscal concepts**

The first necessary step in order to organise our analytical framework consists in specifying the economic meaning, as well as bookkeeping definitions, of some central public finance concepts. Straightforward at the first glance, notions such as “investment”, “amortisation”, “deficit” or “debt”, may hide some definitional ambiguities and, at the end of the day, be sources of great confusion. As a matter of fact, in its attempt to compare the local budget constraints among European countries, Dafflon (2002: 5) counts no less than six distinct definitions of the

concept of “debt servicing”. It is therefore crucial to clarify explicitly the public finance terminology, on which we build our institutional assessment.

For this purpose, the present section obeys the following logic. Inspired by the lessons of the theoretical debate on fiscal discipline (Chapter 1), we begin with the exposition of the so-called theorem of balanced budget, which states the four principles governing the management of public indebtedness. Then, on the basis of this guideline, we formalize the necessary conditions, for the public sector, for having recourse to borrowing. This reasoning, funded on four equations, is referred as the “golden rule” revisited. Finally, we present a standard public accounting framework, which allows us to clarify some fiscal concepts, such as the different measures of public deficit.

#### *4.1.1 The theorem of balanced budget*

Looking successively at the numerous arguments in favour and against fiscal discipline, Chapter 1 shows all the complexity of an issue, which cannot be tackled with a “ready-made” solution. The challenge consists in reaching a compromise between the two opposed positions, namely enforce certain rules governing borrowing decisions, which simultaneously let some room for manoeuvre to governments. Dafflon (1995: 161-162; 1998: 78-79) provides a subtle arrangement, which is articulated into four principles and conciliates both goals. The entitled “theorem of balanced budget” enunciates thus the guidelines of an adequate public sector fiscal equilibrium. This theorem contains the following recommendations:

- *One must distinguish the current budget from the investment budget.*
- *The current budget, which includes the interest payment and the financial amortisation, must be balanced.*
- *Only investment expenditure may be financed by borrowing.*
- *The net surplus results only from the current budget.*

In addition to its many advantages, this set of rules implies interesting corollaries that require further reasoning and therefore, give its weight to the theorem. For now, we just briefly mentioned them without entering into greater details.

First of all, given the separation between current and investment budget, also referred as the capital budget, it is required to precisely define each type of accounting entries in order to avoid any potential strategic behaviour. This bookkeeping distinction further highlights the interesting link existing between investments and current budget, namely the future current expenditures and revenues implied by today's investments. For this reason, the theorem implicitly calls for taking into account the impact of capital expenditures on the current budget. Besides, since borrowing should exclusively serve to finance investments, investment and loan management policies have to be clearly defined and strictly followed. Then, considering the definition of the fiscal balance stated in the theorem, the implementation of an amortisation policy, based on the lifespan of the assets subject to the amortisation, constitutes another corollary consequence. Finally, the investment decisions depending on the capacity of the net surplus to bear the new future current charges, an additional distinction between recurrent and irregular fiscal resources should be made in order to avoid misguided choices. Moreover, the use of the net surplus as an investment criterion may incite the public sector considering the self-financing of certain public tasks through user fees. As explained in the opening chapter (see Subsection 1.1.1), this public financing method, contrary to others, implies an explicit and simultaneous payment, as well as an ideal financial coverage guided by the "user-pays" principle.

On the side of the advantages provided by the theorem, one must firstly underscore that the respect of these principles allows combining, on the one hand, a fiduciary control of the current account with, on the other hand, a managerial control over the investment programmes. Furthermore, the direct relation between the expenditures and the revenues, wanted by the theorem, simplifies the monetary evaluation of the public goods and services produced by the public sector. Last but not least, the required amortisation policy leads to a distribution of the investment costs between the generations over time, as desired by Musgrave's "pay-as-you-use" principle (Subsection 1.2.1).



#### 4.1.2 The “golden rule” revisited

Translated into equations, the theorem of the balanced budget leads to the so-called “golden rule” revisited<sup>53</sup>. Developed by Dafflon and Beer-Thòth (2009: 361-363), this set of formulas aspires to emphasise the ins and outs of the theorem and its corollary implications. Within the framework set in the previous subsection – the distinction between current and capital budget and explicit definitions of the concepts of “investment”, “amortisation” and “debt service” – the golden rule revisited reaffirms the guiding principles of the theorem. It stipulates indeed that only current revenues cover current expenses, that investment expenditure only may justify to have recourse to borrowing, and that servicing the debt is considered as a current cost and, therefore, must be paid out of the current revenues.

Formally, this set of principles can be easily expressed by four equations. With  $T$ , the total current public revenue and  $G$ , the total current public expenditure, the budget balance requirement is achieved if the former is equal to the latter, i.e.  $T = G$ . Taking into account the second principle of the theorem, the first necessary condition in order to contract a new debt lies on the existence of a certain current surplus,  $S$ , able to bear debt servicing (Equation 4.1).

$$T - G = S \quad (4.1)$$

In other respects, an additional investment,  $\Delta I$ , may be financed through various sources. As a matter of simplicity, let us assume that  $\Delta I$  can be covered by a new loan,  $\Delta B$ , or other resources,  $F$  (taxes, transfer revenues, etc.). Equation 4.2 expresses this situation.

$$\Delta I = \Delta B + F \quad (4.2)$$

Consequently, in order to determine the maximal size of the additional investment,  $\Delta I$ , one must still define the maximal amount that can be borrowed;

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<sup>53</sup> The “golden rule” revisited takes its roots in the “golden rule” as described by School of Public Choice (Buchanan and Wagner, 1978). In its initial formulation, the golden rule did not distinguish the current budget from the capital one, which proved too restrictive in order to undertake investment expenditures. It is thus “revisited” in the sense that, it introduces the latter distinction and links it with Musgrave’s “pay-as-you-use” principle. The explanation of the rule is due to Dafflon (1995: 161-162); its formalization to Dafflon and Beer-Thòth (2009: 361-363).

$\Delta B$  depending on the surplus,  $S$ , at the disposal of the jurisdiction. Therefore, following the principles of the theorem, the surplus (before undertaking the new project) has to be large enough in order to bear the future financial implications of the new project. Besides the service of the new debt, this calculation requires taking into account several other parameters regarding, on one hand, the asset (the maintenance costs and the investment subsidies) and, on the other hand, the public good or service provided by the latter (the operating costs and revenues). Equation 4.3 specifies this measurement as:

$$\Delta B = \frac{S - [(M + E) - (R + O)]}{i + d} \quad (4.3),$$

where  $M$  stands for the annual maintenance costs related to the new investment;  $E$ , the annual current costs of the public service that the new investment offers;  $R$ , the revenues earned from the service offered by the investment (user-fees for instance);  $O$ , the operating grants received;  $d$ , the depreciation rate of the investment (depending on its lifespan); and  $i$ , the interest rate.

Compiling the equations 4.2 and 4.3, we are now able to determine the investment capacity of the jurisdiction (Equation 4.4).

$$\Delta I = \frac{S - [(M + E) - (R + O)]}{i + d} + F \quad (4.4)$$

Outwardly simple, the reasoning lying behind the golden rule revisited constitutes an interesting starting point for a deeper reflection about the meaning to be given to the fiscal balance and, more generally, to the concept of fiscal discipline.

#### *4.1.3 The public accounting plan*

One last technical aspect is necessary in the understanding of any fiscal rule: the public accounting framework (or plan). Although the latter does not tell anything about the severity of the fiscal discipline in force, it is however meaningful to grasp its practical articulation, not only in terms of bookkeeping methods, but also in terms of expenditure decision-making. In other words, while the theorem of the balanced budget was the applied translation of the theoretical debate and the

“golden rule” revisited its formalization, the public accounting plan may constitute, to some extent, its tangible implementation.

Rather than describing the bookkeeping methodology, our point is here to emphasise the public accounting specificities as well as the accounting elements regarding the fiscal balance. Knowing that statistics on public finance are directly extracted from the figures published in the public accounts, it is interesting to provide some definitions from an accounting perspective. For example, whereas the term deficit may be simply described as “the excess of expenditures over revenues during a period of time” (Rosen and Gayer, 2010: 461), a full understanding of the meaning of this fiscal figure, for instance in the context of the European excessive deficit procedure, requires a deeper reflection about the accounting aggregates that have to be computed. Because it is coherent with the principles of the above-mentioned theorem under many aspects, let us consider the example of the Swiss public sector accounting plan<sup>54</sup>, schematized in Figure 4-1 and Figure 4-2.

Likewise the bookkeeping of private entities, the fundamental purpose of public accountancy consists in reporting systematically the annual financial flows and keeping track of the assets and liabilities. Thence, as it is organized in the private sector, the public accounting plan should distinctively record the annual monetary and accounting flows, as well as provide a realistic image of the “stocks” of assets and liabilities of the concerned entities. The Swiss plan is no exception and comprises indeed the expense and revenue accounts, grouped within the equivalent of the profit and loss account in the private companies, the current account (Figure 4-1), and balance sheet items (the “stocks”), logically gathered in the balance sheet (Figure 4-2).

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<sup>54</sup> Only the economic classification is discussed here, i.e. the functional classification is left aside.

Figure 4-1: The current and capital budget/account.

Current budget / account		Capital budget / account	
Expenses	Revenues	Expenditures	Receipts
30 Personal	40 Tax	50 Tangible fixed assets (including land, civil engineering works, building construction)	60 Transfer of tangible fixed assets to non-administrative assets
31 Services and fees	41 Royalties and concessions	51 Investments on behalf of third parties	61 Reimbursements
32 Defence	42 User charges and services	52 Investments, intangible fixed assets (including software, patents)	62 Disposal of intangible fixed assets
33 Depreciation	43 Miscellaneous revenue	53 Loans and financial interests n.e.c.	63 Repayment of loans and financial interests n.e.c.
34 Financial expense (including interest payment)	44 Financial revenue (including interest income)	54 Loans	64 Loan repayment
35 Net expense for funds and special financing	45 Withdrawals from funds and special financing	55 Financial interests and share capital	65 Transfer of financial interests
36 Transfer expenses (including revenue shares, compensations, contributions,...)	46 Transfer revenue (including revenue shares, compensations, contributions)	56 Own investment contributions	66 Repayment of investment contributions
37 Subsidies and grants	47 Subsidies and grants	57 Investment contributions	67 Investment contributions
38 Extraordinary expenses (including reserves)	48 Extraordinary revenue (including withdrawals from reserves)	58 Extraordinary investment expenditure	68 Extraordinary investment receipts
39 Internal charging	49 Internal charging		
<b>3 Total current expenses</b>			<b>6 Total investment receipts</b>
<b>4 - 3 = Surplus or net saving on current account (if positive), current deficit (if negative)</b>	<b>4 Total current revenues</b>	<b>5 Total investment expenditures</b>	<b>5 - 6 = Net capital outlay</b>

Administrative budget / account	
<b>Net capital outlay</b>	<b>Surplus</b>
	<b>Net total borrowing</b>

Source: Author's elaboration from the FS-classification by nature published by the Swiss Federal Finance Administration FFA (document available at: <http://www.efv.admin.ch/e/dokumentation/finanzstatistik/berichterstattung.php>)

Having a look at Figure 4-1, we directly notice the main characteristic of this accounting framework, namely the explicit separation between the current and the capital budget/account<sup>55</sup>. The current account collects together all the monetary book entries, which reflect the cash receipts or payments, and the purely accounting entries (formally referred as expenses and revenues) such as the creation of reserves and provisions, or the internal charging. Similarly to the balance of the profit and loss account for a private company, the balance of the current budget indicates the annual variation of the equity capital: a deficit decreases the latter, whereas a surplus increases it.

The existence of the capital account, and in consequence, of the administrative account, constitutes thus the main difference between the public and private accounting method. In a standard private accounting plan, investments are directly mentioned, at their net value, in the assets side of the balance sheet. For a matter of spending control over the undertaken investment programmes, the accounting framework of the public sector should however make accessible their gross value. In order to provide this information, the investment expenditures and receipts are firstly entered into the capital account. The advantage of this way of recording investments entries is twofold. On the one hand, it allows putting easily in parallel the realized expenditures and receipts of each investment and comparing them with the investment programme previously decided by the legislative. On the other hand, the net capital outlay, i.e. the final balance of the capital account, represents the part of the annual investments, which the jurisdiction has to bear. Carrying forward the latter balance into the administrative account, and comparing it with the balance of the current account, the jurisdiction can, at last, determine its needs in financial liabilities, referred as the “net total borrowing” in Figure 4-1.

More than helping in the understanding of the public accounting methodology, Figure 4-1 presents a good opportunity for clarifying the definition of fiscal balance, from the accounting approach. Following the precepts of the theorem of the balance budget, the current account is subject to the balance requirement. This

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<sup>55</sup> The issue of the distinction between the budget and the account is further illustrated in the next section. At this point, in order to simplify, we use only the term “account”.

condition has, however, to be specified. Indeed, the balance should be achieved taking into account the effective current expenses, including the interest payment and the depreciation, and the effective current revenues. Note that purely bookkeeping entries, such as the ones related to the reserves and provisions, or the internal charging are excluded from the calculation<sup>56</sup>. According to this definition of the concept of fiscal balance, the monetary operations concerning investments are not subject to a strict balance requirement. Capital expenditures are rather constrained by the borrowing capacity of the public – itself determined by the current account surplus – as demonstrated in the “golden rule” revisited.

Another concept of fiscal balance is often mentioned in the economic literature, as well as in the media: the primary balance. Defined in the glossary of statistical terms, gathered by the OECD, as the “government net borrowing or net lending excluding interest payments on consolidated government liabilities<sup>57</sup>”, we understand that the primary balance consists in the difference between the current and capital receipts and the current and capital expenditures, where the interest payment and effective amortisation are excluded. The notion of primary balance, and more particularly the primary deficit, is further addressed in the forthcoming chapters, since it is at core of the Maastricht deficit criteria.

Closely related to the issue of fiscal balance, the notion of public indebtedness, i.e. “the sum of all past deficits” (Rosen and Gayer, 2010: 461), can also be approached from an accounting perspective. Investigating the accounting notion of public debt necessitates turning to the public balance sheet (Figure 4-2), whose the value rests mainly on the information it contains concerning the measure of public indebtedness. In fact, regarding strictly its functioning, in terms of accounting method, this document presents less interest than the current and

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<sup>56</sup> One must note that the Swiss public accounting plan presents a major flaw when it comes to distinguish bookkeeping from monetary entries. In fact, in order to operate the distinction, one must be aware that expenses and expenditures (revenues and receipts) cannot be directly pointed from the categories of presented in Figure 4-1. For instance, the category “financial expenses”(numbered 34) contains, as expected, expenditures like interest payment (340), but also bookkeeping entries, like value adjustments on investments (344). Similarly, “extraordinary expenses” (38) contains as many monetary flows (380 extraordinary personnel charges, 383 additional depreciation) as accounting flows (389 net expenses for reserves). The above-mentioned calculation appears thus more complicated.

<sup>57</sup> Definition available at: <http://stats.oecd.org/glossary/>.

capital accounts<sup>58</sup> and, in consequence, we rather concentrate our attention on the measurement of the accounting aggregate, which is at stake.

Figure 4-2: The public balance sheet.

<b>Balance sheet</b>	
<b>Assets</b>	<b>Liabilities and equity</b>
<b>10 Non-administrative assets</b>	<b>20 Liabilities</b>
100 Cash and cash equivalents	200 Current liabilities
101 Receivables	201 Short-term financial liabilities
102 Short-term financial investments	204 Accrued expenses and deferred income
104 Prepaid expenses and accrued income	205 Short-term provisions
106 Inventories and work in progress	206 Long-term financial liabilities
107 Financial investments	207 Liabilities toward government units
108 Tangible fixed assets, NAA	208 Long-term provisions
	209 Restricted funds
<b>14 Administrative assets</b>	<b>29 Net assets/equity</b>
140 Tangible fixed assets, AA	290 Liabilities or advances toward special financing and funds in net assets/equity
141 Inventories, AA	292 Global budget area reserves
142 Intangible fixed assets	293 Advance financing
143 Loans and financial interests n.e.c.	295 Restatement reserve
144 Loans	296 Revaluation reserve
145 Financial interests, share capital	298 Other net equity
146 Investment contributions	299 Accumulated surplus/deficit
147 Assets due from governments units	
148 Accumulated additional depreciation and amortization	
<b>1 Total assets</b>	<b>2 Total liabilities and equities</b>

Source: Author's elaboration from the FS-classification by nature published by the Swiss Federal Finance Administration FFA (document available at: <http://www.efv.admin.ch/e/dokumentation/finanzstatistik/berichterstattung.php>)

Alternatively to the sum of all past deficits, the public debt may be described as all external liabilities of the government and public sector agencies<sup>59</sup>. Neglecting for now the complicated issue of the delimitation of the public sector (and thus of its liabilities), let us focus on the “economic content” of the term liabilities. When stated so (which is the case most of the time), the public debt actually refers to the *gross public indebtedness*. In the public balance sheet, this measure corresponds thus at the liabilities (20), of which we subtract, on one hand, the accounting

<sup>58</sup> For an overview of the specificities of the public balance sheet, see Dafflon (1998: 98-109).

<sup>59</sup> One must note that this definition refers to the “sovereign debt”, which must be distinguished from the “public debt”. Whereas the former takes into account only the liabilities due to private economic agents (outside the public sector), the latter takes additionally in its calculation the liabilities due to other public agents.

entries (204 accrued expenses and deferred income, 205 and 208 short- and long-term provisions, 209 restricted funds), as well as the current liabilities (200), which, like its names says, concern current affairs. Widely used, this measurement of the public indebtedness offers the advantage, on one part, of being quite easily computed (the required fiscal figures are usually available) and also, of resulting in a value, whose link with the interest payment is direct and comprehensible (Dafflon, 1998: 171).

Besides the value of the gross debt, we can logically calculate the *net public indebtedness* by taking into account part of the left side of the balance sheet. The net public debt is thus obtained by deducting, from the gross debt, the financial assets, which could be sold and used to reimbursed part of the external liabilities. Similarly as we have done when calculating the gross debt, the latter criterion imposes us to subtract some irrelevant accounting entries. So, the administrative assets (14) have to be removed. Given that this aggregate represents assets, which are essential for providing public goods and services, they are considered are “inalienable”. The non-administrative tangible fixed assets (108) are also excluded. To be included in the calculation of the net indebtedness, these assets should be evaluated at their market value (not at their accounting residual value, like they are in the balance sheet). Next to the difficult task of estimating the market worth of an tangible good, the government should further adapt this approximation to market variations over time, which represents an additional significant technical inconvenience. Finally, following the same logic as for the computation of the gross debt, all balance sheet items related to current affairs such as some entries of the category 100 (for instance 1000 cash deposit or 1001 post deposit), as well as the accounting entries (104), should not be taken into account.

## **4.2 The analytical framework**

In addition to a clear understanding of the above-mentioned accounting concepts, assessing any fiscal rule requires defining a “benchmark” for comparison. In other words, more than describing the content of the Maastricht criteria, we need to determine first the main features of a hypothetical ideal budget constraint, towards



which we may thereafter evaluate the concerned institutional arrangement. We present here two complementary sets of criteria. The first one, dealing with more general principles, helps to grasp, in its broad sense, what defines an optimal fiscal rule. For its part, the second defines a scale allowing ranking the analysed fiscal rule from soft (the absence of real constraint) to hard (a strict constraint) fiscal constraint.

#### *4.2.1 The criteria of an optimal fiscal rule*

Confronted to the question of the criteria of an optimal rule and inspired by the properties mentioned by Kopits and Symansky (1998: 18-19)<sup>60</sup>, Fatàs *et al.* (2003: 62-65) point out the necessity of distinguishing two dimensions: the *efficiency* and the *enforceability*. While the former aspect refers to the fact of meeting the given objectives at the minimum costs and without implying side effects on the economy, we understand easily that the latter means that the rule can be effectively imposed on the targeted policymakers and their decisions. For each of these two dimensions, the respect of some further principles is obviously required. As far as the achievement of the efficiency target is concerned, one must pay attention at four central principles.

Firstly, the chosen rule must be *consistent with its stated goals*. As revealed by the theoretical debate, fiscal discipline may be desired and justified for several reasons, such as reaching sustainable public finances, avoiding spillover effects in a monetary union or, canalizing politicians' rent-seeking behaviours. Logically, different targeted problems may necessitate distinct rules. In other terms, the question, which has to be answered, is the following: Given the phenomena (or behaviour) that we wish to avoid, what should our fiscal rule concretely restrict? For instance, depending on the goal, a limit on the public deficit may be preferred than one on the public debt. Secondly, an efficient fiscal rule needs to be *credible*. Regardless the goals that are stated in the rule, a credible fiscal constraint implies, on one hand, a clear and effective sanction mechanism, so that the violation of the rule does not constitute a conceivable alternative strategy for decision-makers.

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<sup>60</sup> According to these authors, a fiscal rule should be well-defined, transparent, simple, flexible, adequate, enforceable, consistent and efficient in order to be labelled "ideal". For a discussion about this benchmark, see Creel (2003).

Moreover, this principle also involves that any deviation to the rule may be observable and verifiable in a transparent way. Thirdly, the efficiency of a fiscal rule requires, to some extent, being *adaptable* to changing circumstances. Although the issue of the optimal degree of flexibility remains unsolved, the relevance of this property is however widely acknowledged. Last but not least, the efficiency of the fiscal rule ultimately depends on its *clarity and transparency*. Here, a good decision rule could be: “a simple rule is always preferable to a more complex one” (Fatàs *et al.*, 2003: 63).

Turning now to the second dimension, namely the enforceability of the fiscal rule, some principles must also be followed. First of all, in its formulation, the fiscal rule must precisely specify the chosen constraint, its process of implementation and the sanction mechanism if the latter is transgressed (*well-defined*). Furthermore, the rules and their enforcement modalities should not be subject to amendments, otherwise the temptation of adapting them, in order to achieve the compliance, risks to render the constraint meaningless (“*bindingness*”). Finally, an ideal fiscal rule must contain two additional characteristics regarding its monitoring. First, as we develop in the next subsection, monitoring compliance should optimally intervene *ex post*, on the basis of the realized accounts, rather than *ex ante*, on the basis of the budget (*timing of the monitoring compliance*). Secondly, this task should be assigned to an independent body, whose functioning is transparent and the decisions enforced without allowing the opportunity of being cancelled by a third institutional body (*independence of the body in charge of the monitoring compliance*).

#### 4.2.2 Assessing the degree of strictness

Now that the fundamental principles, which an optimal fiscal rule must follow, have been emphasised, we can address the issue of ranking the existing fiscal rules and, more specifically evaluate their degree of strictness. In order to do so for the Maastricht budget constraint, we use a well-proven methodology consisting in answering a series of seven questions, which ultimately allow determining the severity of the concerned fiscal rule. Initially developed by

Dafflon (1996: 240-243), this sequence of questions<sup>61</sup> has been, since then, applied successfully in several different contexts but never to the so-called Maastricht criteria.

Figure 4-3 summarizes the seven questions to be addressed, as well as the six possible grades of strictness, going from “no constraint” (path 1) to “strict budget discipline” (path 6). Let us review, from the beginning (at the top of Figure 4-3), the seven issues to be successively tackled and their related problems.

1. Is any sort of balance budget or fiscal discipline requirement prescribed by the law or the constitution?
2. If the law, or the constitution, provides such disposition, does it concern the budget, the account or both?

This distinction between what is planned (and, consequently, depends on assumptions) and what is realised is indeed of great importance. To illustrate our point, let us consider Table 4-1, which presents the nine possible fiscal outcomes. Except outcomes 1, 2, 4 and 5, which respect fiscal discipline, the others are, on the contrary, sources of problems. Regarding outcomes 7 and 8, the budget forecast is too pessimistic and records a deficit, which should activate a process of correction. Looking at the account, the deficit of the budget either appears to be a false alert, or proves that the corrections have been effective. In outcomes 3 and 6, the budget is in surplus, respectively in balance, and so, is conform to the fiscal constraint. Nevertheless, the account shows a deficit, which should trigger sanctions. Through the two types of situations, we understand the necessity to implement differentiated mechanisms of sanction. Logically, outcomes 7 and 8 cannot be solved in the same way than outcomes 3 and 6. For its part, outcome 9 means that the corrections implemented on the budget have not been successful.

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<sup>61</sup> In its original formulation, the method refers to six fundamental questions. We choose here to divide the second one into two distinct steps.

Table 4-1: *The possible fiscal outcomes.*

		Account		
		Surplus	Balanced	Deficit
Budget	Surplus	1	2	3
	Balanced	4	5	6
	Deficit	7	8	9

Source: Dafflon (2010: 13).

Apart from the need of distinct measures of corrections, Table 4-1 shows the great limit of an *ex ante* fiscal rule in its attempt of guarantying fiscal discipline.

3. What is the definition of the fiscal discipline? Does it involve the balance of the public budget/account as a whole, i.e. the current and capital budget/account together, or exclusively the current one?
4. Are the amortization expenses included in the accounting balance, which is subject to fiscal discipline? If so, how is the amortization rates defined? Do they coincide with the debt repayment?
5. In which timeframe should the fiscal criteria be achieved?

The strictest rule would set a balance requirement on an annual basis. Alternatively, we can imagine a fiscal constraint, which either takes into account the average balance over a given number of fiscal years, or prescribes a deadline for meeting the criteria. In the latter cases, the fiscal rule grants more intertemporal flexibility in fiscal policy at the expense of potential strategic behaviour and ultimately, softer fiscal constraint.

6. If the criteria should not be achieved on an annual basis, but rather in a medium term, how is this time horizon defined?

In line with the previous question, the issue here consists in determining if the definition of the “medium term” is adequate. This definition should indeed contain the length of the timeframe, its beginning and, in order to limit politicians’

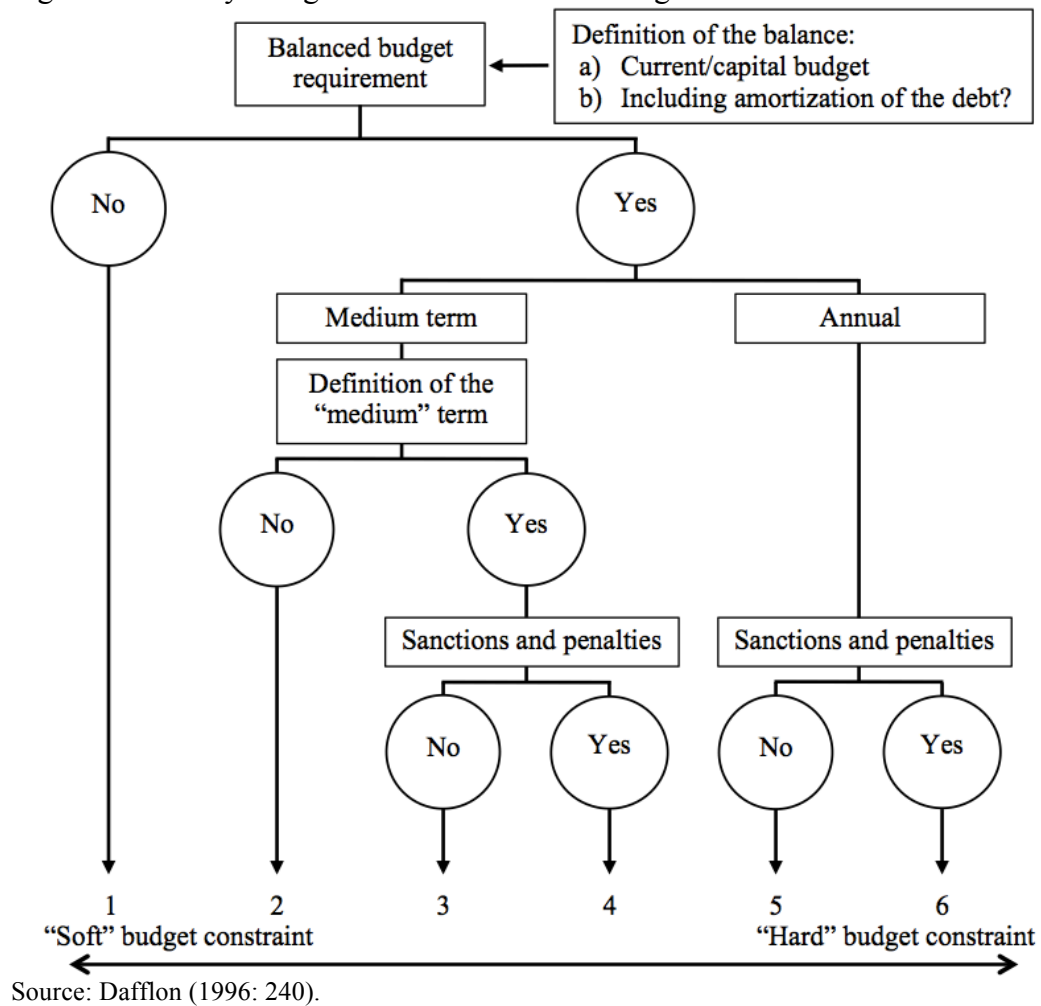
strategic behaviours, the “medium term” should match the duration of the political term. Regarding the last definitional property, one has to adopt a standard public choice approach in order to understand its importance. Imagine that the compliance with the fiscal rule should be achieved within five years, while the political term lasts for four years. Assuming that both start simultaneously, it is likely that the politicians in office until  $t_4$  would let the difficult task of promoting fiscal discipline to the next political term. The same reasoning works also if the beginning of both periods does not coincide.

7. In case of violation, does the rule provide sanction mechanism?

More than the existence of a sanction mechanism, the real issue remains its effectiveness and its enforceability. Furthermore, the penalties prescribed by the rule must be designed so as to create the desired incentives, namely the respect of fiscal discipline.

Looking now at the arrival positions of the different path, we understand that either the lack of clear definition of the medium term, or the absence of effective sanction and penalty mechanism, seriously weakens the scope of the constraint and may potentially make it ineffective. Besides, in a recent international symposium, Dafflon (2012) switches path 4 and 5, considering that a rule, defining correctly the targeted medium-term balance and providing sanctions in case of violation, may produce better fiscal outcome than an annual constraint without any real risk of sanction.

Figure 4-3: Analytical grid of the strictness of budget constraints.



## 5 The institutional framework of Maastricht criteria

Since their first evocation in 1991 during the Maastricht Summit until now, the European instruments devoted to fiscal discipline and, more generally, the institutional fiscal environment, in which they are implemented, have known several modifications of varying depth. Influenced by political and/or economic circumstances, these evolutions have taken different forms. Thereby, the existing legal bases have been sometimes amended and, in some other cases, been completed with additional legal provisions. Therefore, the resulting institutional framework consists not only in a *succession of amendments*, but also in a construction of *overlapping legal acts* of different nature. Table 5-1 gives a global overview of this institutional assembly by listing all the related legal sources and their amendments<sup>62</sup>. The present chapter attempts thus to clarify this intricate institutional arrangement by investigating each of the associated pieces of law in force nowadays.

Before getting to the heart of the matter, one must first understand the essential articulation of the European legal texts. Looking again at Figure 5-1, we note indeed that “Regulations” and “Directives” border on “Treaties” and “Protocols”. In fact, the European legal framework makes the distinction between the *primary law*, i.e. the founding treaties, as well as the protocols annexed to them, and the *derived law*, comprising regulations, directives, decisions, recommendations and opinions, as listed in Art. 288 of the Treaty on the Functioning of the European Union (TFEU) (Dutheil de la Rochère, 2010: 80). Although both primary and derived law are legal acts, they may imply major differences in their modality of implementation at the national level. For instance, whereas a regulation is “binding in its entirety and directly applicable in all Member States”, a directive establishes a common aim for all member states without specifying its form in the national legislation. A recommendation or an opinion has no binding force (Art. 288 TFEU). Since the description of the European fiscal constraint requires going through several sources of both primary and derived law, this hierarchisation of the EU legal acts has to be kept in mind.

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<sup>62</sup> The legal bases presented in Figure 5-1 are placed on the time axis according to their publication date and not when they entered into force.

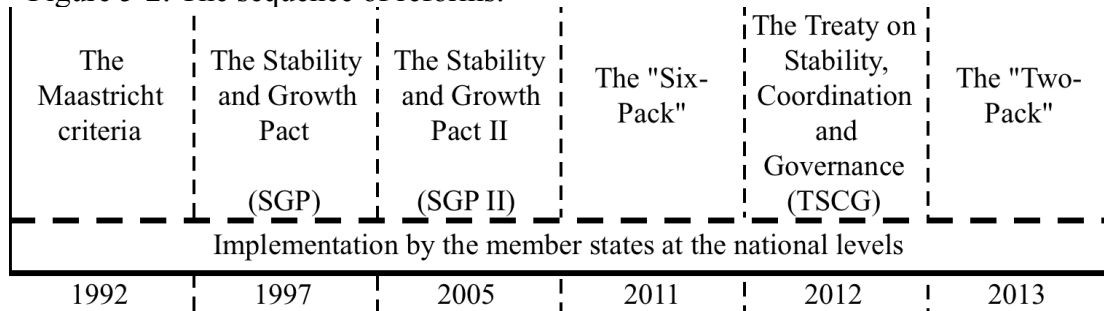
Figure 5-1: The relevant legal sources of the European budget constraint.

The Maastricht criteria			REGULATION No. 3605/93		No. 475/2000		No. 2103/2005		No. 479/2009		No. 679/2010											
	TREATY of Maastricht (TEC)		TREATY of Amsterdam		TREATY of Nice		PROTOCOL No. 12 on the Excessive Deficit Procedure															
							RESOLUTION of the European Council on the Stability and Growth Pact															
							REGULATION No. 1467/97		REGULATION No. 1056/2005													
							REGULATION No. 1466/97		REGULATION No. 1055/2005													
The "Fiscal Compact"																						
The "Two-Pack"																						
The "Six-Pack"																						
TREATY of Lisbon (TFEU)																						
	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013



Although the European fiscal environment is the result of a continuous succession of adjustments since 1992, several main steps have marked this evolution. Figure 5-2 schematizes these cornerstones, going from the mentioning of the ground principles in the Maastricht Treaty, to the most recent discussion around the so-called “Two-Pack”, which has been published in the Official Journal of European the Union in May 2013.

Figure 5-2: The sequence of reforms.



Finally, looking at Figure 5-2, one last remark has to be formulated regarding the distinction between the institutional fiscal arrangement in force at the Union’s level (the upper part of the schema) and its translation into the national legislations (the bottom part). In fact, the focus of the present Master’s Thesis, i.e. the European fiscal constraint, provides “only” a supranational framework, which let to the member states a certain room for manoeuvre in terms of implementation. As a consequence, the individual national interpretation would need further investigations. This issue goes however beyond the scope of our study and is therefore not addressed here.

The forthcoming description of the European fiscal instrument follows the sequences of Figure 5-2. We begin with the presentation of the guiding principles that have appeared in the Maastricht Treaty and have initially conditioned the participation in the EMU (Section 5.1). Then, we turn to the Stability and Growth Pact (SGP) and its main amendment, which took place in 2005 (Section 5.2 and 5.3). Section 5.4 analyses the content of the so-called “Six-Pack”, which takes its name from the five regulations (three additional and two amendments) and one directive that it counts. Entered into force on 1<sup>st</sup> January 2013, the Treaty on Stability, Coordination and Governance (TSCG), whose fiscal part is commonly

referred as the “Fiscal Compact” is exposed in a fourth section, whereas the most recent “Two-Pack” regulation is described in a concluding section.

### **5.1 The ground principles and components of the Maastricht criteria**

The Maastricht Treaty, entered into force on 1<sup>st</sup> January 1995 and officially named the Treaty on European Union, marked formally the starting point leading to the creation of the EMU in 1999. In fact, this Treaty not only scheduled the stages for monetary integration but also set the requirements for joining the EMU. Among the latter conditions, we find the two criteria regarding the member states’ public finances, which are at the root of the current European budget constraint.

Although the successive amendments that the Maastricht Treaty has known over the years<sup>63</sup>, the rules defining the main institutional framework, which aims at limiting the national fiscal policies, are still present in the Consolidated Treaties, established in 2007 in Lisbon and entered into force in December 2009. Identical in their formulation, these articles have however been renumbered. We wish thus to draw the reader’s attention on the fact that the following analysis refers to the most recent numbering<sup>64</sup>. Apart from the new numbering, note that the Treaty of Lisbon also introduced formally the Eurogroup – a configuration of the Council, where only the ministers of the Eurozone are represented – and slightly changed the voting rules within the Council of the European Union (usually referred to as the Council).

The legal expression of the fiscal Maastricht criteria takes place under Title VIII of the TFEU, entitled “Economic and Monetary Policy” and, more precisely, in its Chapter 1 dedicated to the economic policy. For its part, Protocol No. 12, annexed to the Treaties, specifies the Excessive Deficit Procedure (EDP) and some notions mentioned in the TFEU. When it was introduced, the EDP was further completed with a Council Regulation (No. 3605/93), which settles its modality of application regarding particularly the duty of the member states to report their fiscal figures.

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<sup>63</sup> The Amsterdam Treaty in 1999, the Nice Treaty in 2003 and finally the Lisbon Treaty in 2009 have successively amended the original Maastricht Treaty (dates of their entry into force).

<sup>64</sup> The Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union provides tables of equivalence between the old and new numbering of both Treaties. However, no guideline has been officially defined regarding the manner to refer to the pre and post reform Treaty articles. Consequently, and for a matter of simplicity, we use only the last numbering, in force in the Lisbon Treaty.

Over the years, this Regulation has been amended at several occasions (see the third line from the bottom in Figure 5-1). Whereas some of the successive amendments remained minor and consisted only in some renumbering or references or articles (No. 475/2000, No. 351/2002, No. 679/2010), some others introduced modifications of greater relevance (No. 2103/2005, No. 479/2009). Therefore, one must note that the present section analyses the legal bases currently in force, without necessarily retracing the modifications that have been established in the past. In clear, the legal bases that constitute, today, the “plinth” of the European fiscal rule, are the TFEU, the Protocol No.12, and the Council Regulation No. 479/2009, as well as its last partial amendment (Council Regulation No. 679/2010).

In order to extract the main features of the initial Maastricht criteria, which, more than any other following legal bases, give its taste to the European fiscal constraint, the section is divided into four subsections. After having exposed the guiding principles of this fiscal instrument and its general functioning, the next subsections aim at putting into light three specific issues. Thereby, we study successively the definition of the public sector, the notions of public deficit and debt, and finally the rules governing the reporting and monitoring of the national fiscal figures.

#### *5.1.1 The general design*

Our description of the general design of the European fiscal constraint is guided by the following logic: the setting of a target, a precise definition of the conditions to be fulfilled for achieving the latter (as well as the tolerated exceptions), and the description of the sanction mechanism in case non-compliance.

As far as the fiscal target is concerned, the TFEU does not provide a clear and unique answer. According to Art. 119(3), which defines four guiding principles for the EU economic and monetary policy, the central objective of the European fiscal policy consists in the achievement of “*sound public finances*”. To provide the means to achieve this particular goal, Art. 126 draws the broad outlines of the excessive deficit procedure (EDP) and exposes the core principles of the European fiscal constraint. First of all, the latter article specifies the interpretation

to be given the above-mentioned goal of “sound public finances”. Para. 1 states indeed that, “*member states shall avoid excessive government deficits*”. In other words, the public finances of the member states may be labelled as “sound”, not when they are in balance, but as far as their fiscal balance does not record an “excessive deficit” – quite a nuance and a departure from the “golden rule” of public finances. Given this fiscal target, the requirement of setting some criteria is obvious. In order to determine the soundness of the public finance stance of its member states, the EU must state, at least, what makes a public deficit excessive or not.

The second paragraph of the same article not only answers the question of the relevant criteria for differentiating an excessive from an acceptable public deficit, but also introduces another necessary condition of sound public finances. By doing that, the TFEU slightly modifies the concept of fiscal discipline that was implied in its initial fiscal objective. Art. 126(2) expresses indeed that, in addition to “the budgetary situation” (the deficit), “the stock of government debt” should also be monitored. Accordingly, the compliance with budgetary discipline shall be measured on the basis of the two following criteria:

- *The ratio of the planned or actual government deficit to gross domestic product;*
- *The ratio of government debt to gross domestic product.*

Both criteria are subject to a respective reference value specified in Protocol No. 12. Art. 1 of the Protocol sets indeed the reference value for the deficit-to-GDP ratio at *3 per cent*, and the one for the debt-to-GDP ratio at *60 per cent*. The idea is that, beyond these reference values, a mechanism of corrections and, *in fine*, of sanctions, should be triggered. However, the TFEU provides “exit doors” to the respect of the rules. In clear, under some conditions, the reference values could be exceeded, i.e. the member states are allowed to infringe the rules, without initiating the procedure of sanctions. Regarding the deficit criteria, two conditions for derogating from the rule are envisaged. Firstly, an exceeding deficit ratio may be indeed tolerated, if the successive yearly ratios have “declined substantially and continuously” and have come “close to the reference value”, or secondly, if

the violation remains “exceptional and temporary” with a value remaining “close to the reference value”. For the indebtedness criteria, only one situation may justify a debt-to-GDP ratio above the limit. Such cases are indeed tolerated under the condition that the concerned value is “sufficiently diminishing and approaching the reference value at a satisfactory pace”.

The European Commission (hereinafter referred to as “the Commission”), the initiator of legislative proposals and executive arms of the EU, is in charge of monitoring the compliance of the fiscal stance of the member states with the criteria (Art. 126(2)). This mandate implies that, when the deficit and/or the debt ratio of a member state happen to exceed the reference values, or risks to do so, the Commission must prepare a report. After being subject to the opinion of the Economic and Financial Committee (EFC)<sup>65</sup> (Art. 126(4)), the report of the Commission is transmitted to the concerned member state, as well as to the Council. Based on the document of the Commission and the potential further observations provided by the member state itself, the Council must adjudicate on the existence of a situation of an excessive deficit (Art. 126(6)). Put differently, the Council must confirm the assessment of the Commission before taking any measures of correction.

Once the situation of an excessive deficit is proven and confirmed, the Council opens a procedure of fiscal correction, which should bring the fiscal stance of the targeted member state to an acceptable level. In order to make the correction effective, the Council has different instruments at its disposal. On one hand, the Council must present solutions to the issue; on the other hand, it may use several means of pressure, supposed to encourage the member state to tackle promptly its fiscal problem. Concretely, the Council gives its advices to the member state through a recommendation. The latter document, possibly inspired by a preparatory work of the Commission, should sketch solutions allowing to bring this situation to an end, within an appropriate period of time. At this point, the Council’s recommendation shall remain confidential (Art. 126(7)). Providing that

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<sup>65</sup> The EFC gathers senior officials from national administrations and central banks, the ECB and the Commission. Its aim consists in promoting policy coordination among the Member States by providing opinions to the Commission and the Council.

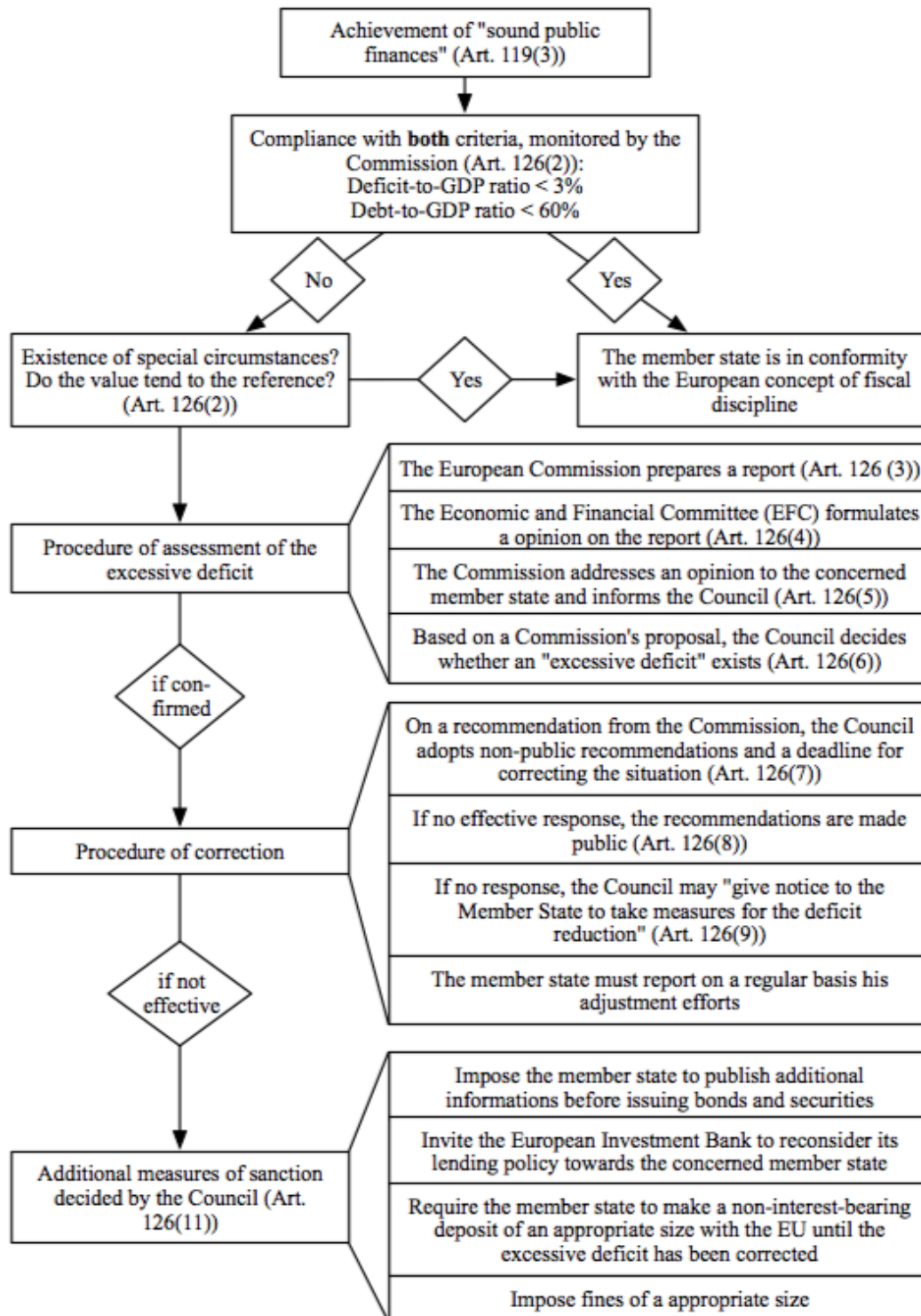
the member state follows the Council's proposal and undertakes the appropriate actions in order to improve its fiscal situation, the latter document is not made public. On the contrary, if the response of the member is unsatisfactory and its action ineffective, the Council may attempt to put further pressure on the concerned government by deciding to publish its recommendation (Art. 126(8)). Similarly, if the concerned government persists not responding to the Council's request, it may be constraint to "submit reports in accordance with a specific timetable" (Art. 126(9)).

At this point, if the correction procedure has not born fruit, i.e. the member state fails to comply with the measures of deficit reduction recommended by the Council, Art. 126(11) provides the EU decision-making body with several tools of sanction. The TFEU lists indeed four measures expected to intensify the pressure put on the member state:

- The Council may impose additional conditions on the issuing of bonds and securities of the concerned member state.
- The Council may intercede with the European Investment Bank and advice it to reconsider its lending policy towards this government.
- The Council may require a non-interest-bearing deposit with the EU from the member state. This amount is returned to its owner once the Council deems that fiscal discipline is achieved.
- Ultimately, the Council may impose non-refundable fines.

When the member state has, "in the view of the Council", corrected its excessive deficit, the Council has to abrogate the above-mentioned measures. Moreover, if the case of non-compliance with the fiscal criteria has been made public, the Council must state publicly the end of the procedure. Figure 5-3 sums up the complete procedure described in the TFEU.

Figure 5-3: The initial European fiscal constraint.



As our reading of Art. 126 made clear, the Council of the European Union serves as the main decision-making body: it decides whether an excessive deficit exists, it chooses to make its recommendations public, it may constraint the member states to take measures for deficit reduction and, ultimately, it has the power of imposing sanctions, as well as abrogating them. Therefore, it makes sense to focus shortly on its composition and voting procedure.

The Council is “the voice of the EU member states” (European Commission, 2012: 14) and is thus composed by one minister from each government (15 in 1995, 25 in 2004 and 27 since 2007), which benefit from a decision power depending on the size of its population (Table 5-1).

Table 5-1: *Votes per country in the Council.*

Member state	Number of votes
Germany, France, Italy, United Kingdom	29
Spain, Poland	27
Romania	14
Netherlands	13
Belgium, Czech Republic, Greece, Hungary, Portugal	12
Austria, Bulgaria, Sweden	10
Denmark, Ireland, Lithuania, Slovakia, Finland	7
Cyprus, Estonia, Latvia, Luxembourg, Slovenia	4
Malta	3
<b>Total</b>	<b>345</b>
Number of votes required for qualified majority	255

Source: European Commission (2012: 16).

The Council may take different configurations depending on the subjects being discussed. For instance, when addressing issues concerning education, the Council gathers the national ministers of education. Similarly, the “specialized” ministers discuss economic and monetary matters and, among those, the fiscal issues. In the latter case, the Council is referred to as the “Ecofin Council” (Economic and Financial Affairs) and gathers the economics and finance ministers of the 27 member states, regardless whether they participate or not in the monetary union. This last point is not without creating some problems since participating and non-participating member states do not stand under the same fiscal constraint, nor face the same risks<sup>66</sup>. Aware of the issue, a “subset” of the

<sup>66</sup> Since 2011 and the adhesion of Estonia to the EMU, only 17 out of 27 EU member states have the common currency.



Ecofin Council, bringing together exclusively the economics and finance ministers of the euro area, has been established: the *Eurogroup*. Informal at its beginning<sup>67</sup>, its role and its competences have however increased over the years until it obtained a legal basis in the Lisbon Treaty. Thereby, Protocol No. 14, annexed to the consolidated Treaties, confirmed the informal nature of these meetings, where the participating member states “discuss questions related to the specific responsibilities they share with regard to the single currency”. In addition to this Protocol, the Lisbon Treaty introduced further “provisions specific to member states whose currency is the euro” (Art. 136 to 138 TFEU), which constituted a significant evolution in the decision-making process within the Eurozone. Art. 136 stipulates indeed that, as far as the procedure described in Art. 126 (the EDP) concerns participating member states, “only members of the Council representing member states whose currency in the euro shall take part in the vote” (Art. 136(2))<sup>68</sup>. The decisions are made at the *qualified majority*, which is defined as “at least 55 per cent of the member of the Council representing the participating member states, comprising at least 65 per cent of the population of these states” (Art. 238(3)(a)). Compared to the initial provisions of the Maastricht Treaty, according to which the Council as whole takes part in the decision specific to the participating countries, such issues are now addressed, still formally within the Ecofin Council, but taking only into account the votes of the concerned countries.

Note finally that, as a rule, a member state (participating or not) concerned by the procedure described in Art. 126 is excluded from the Council’s vote. This rule applies for the confirmation of the excessive deficit (Para. 6) and all the following measures decided by the Council (Art. 126(13)). Concretely, it means that, when the Council has to decide whether it imposes or not a sanction to a non-compliant country, the latter member state does not take part to the vote.

Until now, our description of the European fiscal constraint, based essentially on the founding Treaty, let many aspects of the rule open to various interpretations.

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<sup>67</sup> The Eurogroup met informally for the first time in June 1998.

<sup>68</sup> Art. 126(14), which is related to the competence of amending and setting the principles of implementation, is an exception to the rule.

In fact, the reader of the articles dedicated to fiscal discipline in the TFEU may find some components of the procedure quite ambiguous. To name only a few examples, we note that the issues of the coverage of the criteria, the exact definitions of the constrained fiscal aggregates, or the concrete meaning of the exceptions justifying the non-compliance, are not clearly addressed. Furthermore, it is not clear whether the two criteria, the deficit-to-GDP ratio and the debt-to-GDP ratio, have the same weight in the appreciation of the Commission, the EFC and, ultimately, the Council.

In order to investigate further these several points (in so far they are actually tackled), the next subsections analyse the legal bases surrounding the articles of the Treaty, namely the Protocol No. 12 on the Excessive Deficit Procedure and the Council Regulation No. 479/2009 on the application of the Protocol and its last partial amendment (No. 679/2010). Complementary to these legal sources, the European System of National and Regional Accounts (ESA 95)<sup>69</sup> needs also to be studied, since it provides the accounting framework in force at the European level.

#### *5.1.2 The coverage of the “government”*

As stated in the TFEU, the ratio of the government deficit, respectively of the government debt, to GDP shall not exceed a reference value. In order to deeply understand the consequences of these two criteria on the public finances, it is necessary to specify the European definition given to the term “*government*”. Straightforward in appearance, the issue deserves however to be seriously tackled. Indeed, paying attention to the latter proves to be crucial for, at least from our point of view, two reasons. On the one hand, the measure of the “government” is at the core of the Maastricht fiscal constraint. Whether for the deficit or the debt criteria, before computing the latter accounting aggregates, we need to determine first the institutional units, which have to be taken into account in the calculation. In consequence, defining what “belongs” to the public sector, or not, represents an

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<sup>69</sup> When the Maastricht criteria have been established, the European System of Integrated Economic Accounts (ESA) was still in force. It has, however, been replaced in 1996 by the ESA 95. Moreover, a number of changes have been introduced to this version since then, in the form of legal amendments. In consequence, the legal bases, surrounding the European fiscal constraint and related to its accounting interpretation, have been amended accordingly. For a matter of simplicity, we refer directly to the updated version, which is available at: <http://circa.europa.eu/irc/dsis/nfaccount/info/data/esa95/esa95-new.htm>.

essential preliminary step. On the other hand, as important as it is in the context of the European fiscal rule, the determination of the scope of the public sector remains a difficult exercise subject to methodological variations<sup>70</sup>. Given that, nowadays, the state is engaged in numerous activities, which are undertaken according to various modalities, it becomes sometimes complicated to draw a clear line between the public and the private sector. In fact, we observe not only that the public sector occasionally produces market goods and services as a private firm would do, but also that the non-market goods and services are not exclusively provided by the public sector. The well-known system “public-private partnership” (PPP) exemplifies perfectly the latter case and, more generally, the difficulty of distinguishing the public from the private sector. As a matter of fact, depending on where the limit is set, the “size” of the government considerably varies. At this point, we can already note that this “gray area” may potentially be used as a strategic tool: the exclusion from the perimeter of the public sector of some tasks contributes mechanically to relax the constraint.

Reviewing the three legal bases of the Maastricht criteria (the TFEU, the Protocol No. 12 and the Council Regulation No. 479/2009), the first reference to the “European definition” of the public sector takes place in Art. 2 of the Protocol. The latter makes the following statement:

*“Government” means general government, that is central government, regional or local government and social security funds, to the exclusion of commercial operations, as defined in the European System of Integrated Economic Accounts.*

Council Regulation No. 479/2009 (Art. 1(2)) confirms this definition and complements it only with the references of the concerned institutional units, as well as with more details regarding the treatment of commercial operation:

*“Government” means the sector of “general government “ (S.13), that is “central government” (S.1311), “state government” (S.13.12), “local government”*

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<sup>70</sup> Dafflon (2013: 3-12) presents and assesses three methods that allow defining the public sector. The scope of the public sector may be thus delimited (1) by the enumeration of the institutional units constituting the public sector, (2) by the decision-making process and (3) by the property of the production factors. More precisely in reference to the canon of public finance, one may define it by the definition of “public goods”, a commodity that *nonrival* and *nonexcludable* in consumption (Rosen and Gayer, 2010: 54-56).

*(S.13.13) and “social security funds” (S.1314), to the exclusion of commercial operations, as defined in ESA 95.*

*The exclusion of commercial operations means that the sector of “general government” (S.13) comprises only institutional units producing non-market services as their main activity.*

Despite learning that the term “government” refers to a consolidated measure of all three levels of governments plus social security funds, but minus the units producing mainly commercial operations, both definitions remain empty of greater details and, instead, simply refer to the ESA 95. A deeper analysis of the latter document is therefore required.

The ESA 95 lies on a logic initially developed by the IMF in the mid-1980s, which led first to the development of the international System of National Accounts (SNA 93) implemented worldwide and published jointly by the European Commission, the IMF, the OECD, the UN and the WB. Basically, it consists in a global statistical system, which divides each national economy into six institutional sectors. These sectors may be further subdivided into sub-sectors. Table 5-1 presents the exhaustive list of the sectors and sub-sectors defined by the ESA 95. Besides the public sector, i.e. the general government (S.13, framed in red in Table 5-2), the ESA 95 distinguishes the non-financial corporations (S.11), the financial corporations (S.12), the households (S.14), the non-profit institutions serving households (S.15) and the so-called “rest of the world” (S.2).

Table 5-2: *The institutional sectors and sub-sectors in the ESA 95.*

Non-financial corporations	S.11
	S.12
Financial corporations	
Central Bank	S.121
Other monetary financial institutions	S.122
Other financial intermediaries, except insurance corporations and pension funds	S.123
Financial auxiliaries	S.124
Insurance corporations and pension funds	S.125
General government	S.13
	S.1311
Central government	
State government	S.1312
Local government	S.1313
Social security funds	S.1314
Households	S.14
	S.141 + S.142
Employers (including own account workers)	
Employees	S.143
Recipients of property incomes	S.1441
Recipients of pensions	S.1442
Recipients of other transfer incomes	S.1443
Others	S.145
Non-profit institutions serving households	S.15
Rest of the world	S.2
	S.21
The European Union	
The member countries of the EU	S.211
The institutions of the EU	S.212
Third countries and international organisations	S.22

Source: ESA 95 (<http://circa.europa.eu/irc/dsis/nfaccount/info/data/esa95/en/een00069.htm>).

In this context, the public sector is defined by the enumeration of the institutional units constituting it. According to Para. 2.68, which provides a first general definition of the “general government”, two kinds of institutional units, belonging to S.13, must be distinguished:

- “All institutional units principally engaged in the redistribution of national income and wealth”

- “The other non-market producers<sup>71</sup> whose output is intended for individual and collective consumption, and mainly financed by compulsory payments made by units belonging to other sectors”

The following paragraph of the ESA 95 (2.69) goes further and lists the institutional units, which belong to the two above-mentioned types of units. The general government is thus constituted by:

- “General government entities (excluding public producers organised as public corporations or, by virtue of special legislation, recognised as independent legal entities, or quasi-corporations, when any of these are classified in the non-financial or financial sectors) which administer and finance a group of activities, principally providing non-market goods and services, intended for the benefit of the community;
- non-profit institutions recognised as independent legal entities which are other non-market producers and which are controlled and mainly financed by general government;
- autonomous pension funds<sup>72</sup>.”

In respect with these definitions, the general government can be divided into four sub-sectors. The ESA 95 distinguishes thus the central government (S.1311), the state government (S.1312), the local government (S.1313) and the social security funds (S.1314). S.1311, S.1312 and S.1313 include, at their respective level – central, regional and local – all administrative departments and other public agencies. These sub-sectors also include all non-profit institutions which are controlled and mainly financed by each layer of government and whose competence extends over its political territory. On the contrary, the administration of social security funds is excluded from the latter sub-sectors but appears in S.1314, its own category. This fourth sub-sector includes thus “all central, state and local institutional units whose principal activity is to provide social benefits”

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<sup>71</sup> Para 3.26 specifies further the term “other non-market producers” and defines it as: “local KAUs (kind-of-activity unit) or institutional units whose major part of output is provided free or at not economically significant prices.”

<sup>72</sup> Note that the inclusion of autonomous pension funds to the general government is conditional. The minimum requirements are similar to the ones defining the inclusion of social security funds to the general government. Those are developed in Para 2.74. We also mention them later in the text.

(Para. 2.74). The inclusion to S.1314 is furthermore subject to two conditions. Firstly, the personal contributions financing these funds must, to some extent, be mandatory. Besides, the amount of the contributions paid by each individual should not, in principle, be linked to the risk, to which he is exposed – the principle of distribution contrasting with the principle of capitalization. Secondly, the general government must be responsible for the settlement or approval of the contributions and benefits.

As detailed as may be seen this set of categorisation principles, when it comes to determine whether an economic entity belongs or not to S.13, the task can be tricky. In order to make the decision-making easier (and probably clearer), Eurostat (2013: 11-16), in its Manual on Government Deficit and Debt, points out the essential characteristics of a public sector entity and specifies the concepts behind those. In this manual of implementation, Eurostat extracts thus three main determinants from the above-mentioned rules. So, in order to belong the general government, an entity must be simultaneously: *an institutional unit, a public institutional unit, a non-market public institutional unit*.

Following this methodological way, the determination of the affiliation to the public sector begins with the decision whether the concerned transactions are part of an institutional unit in the sense of the ESA 95. The concept of “institutional unit” is defined in Para. 2.12. It states that “the institutional unit is an elementary economic decision-making centre characterised by uniformity of behaviour and decision-making autonomy in the exercise of its principal function”. In order to fulfil these two criteria, the entity must:

- be able to possess its own goods and assets, as well trading them with other units of the same nature;
- be free of making economic decisions and undertaking economic activities;
- be able to commit itself, i.e. incur liabilities, take on obligations;
- and keep (or at least, could keep) a complete set of accounts.

If these criteria are not met, the transactions of the entity must be allocated to the unit that controls it; so to say, its parent.

Then, the ESA 95 considers an institutional unit as “public” as long as the unit is under the control of the public sector. The notion of “control” is specified as the power of deciding the general, as well as corporate, policy of the unit. This is the case when the government owns more 50 per cent of the share of the corporation. Governmental control can also take the form of special legislations that empowers the government to determine corporate policy or to appoint the directors. Whereas the compliance with the former criterion is easy to verify, the latter may be subject to various interpretations. In order to clarify the notion of “control”, Eurostat illustrates its point with the example of two schools; one being under the control of the general government, the other one not. The general government controls the school if its approval is needed to create new classes, make significant investments, or borrow. On the contrary, the given school does not belong to S.13 if the general government just finances the school or supervises the general quality standards or the teaching programmes.

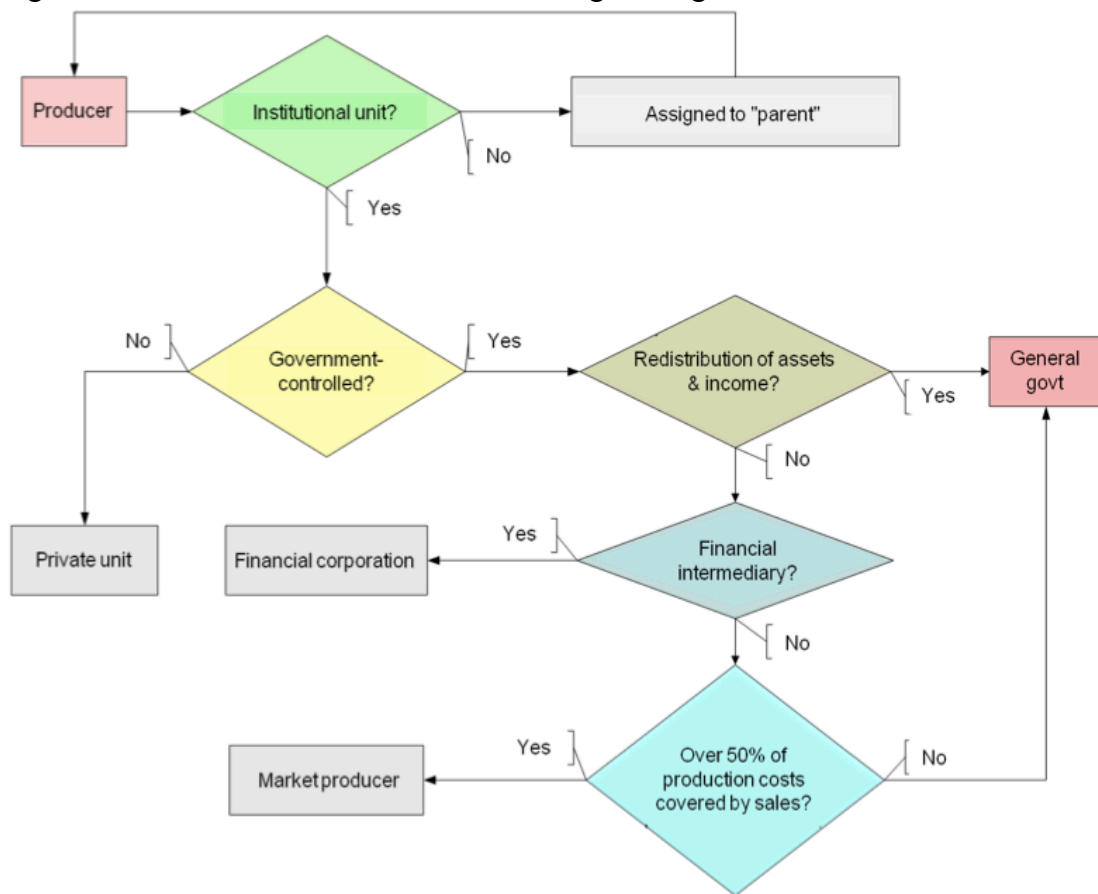
Finally, the public institutional unit must satisfy the so-called “non-market rule” in order to belong to the general government. The respect of this criterion requires the assessment of the main function exercised by the entity. A public institutional unit can indeed perform different types of function, which ultimately determine its assignment to the to S.13. For instance, when the entity exercises the function of national income and wealth redistribution, which comprises levying taxes, paying grants or providing social benefits, the unit is to be classified in the general government sector. On the contrary, when a public entity performs mainly the function of financial intermediation, such as health insurers or some pension funds, the unit does not belong to the public sector since, in the sense of the ESA 95, they are market oriented. If the function of the unit is nor the redistribution, neither the financial intermediation, it is then necessary to determine whether its output is aimed at being sold for *economically significant prices*. The border between market and non-market producer being potentially thin, Eurostat calls for the implementation of the so-called “50 per cent criterion”. In clear, it means that



the output is sold at economically significant prices when more than 50 per cent of the production costs are covered by the sales<sup>73</sup>.

Without entering now into the details, we already notice the strong impact, which this rule may have on the scope of the public sector. Think, for instance, about the hospitals, the retirement and care homes, the wastewater treatment plants or the electricity power plants, whose sales may easily be superior to 50 per cent. According to the European sectoring rules, all those entities would belong to the sector of non-financial corporation (S.11).

Figure 5-4: Decision tree for allocation to the general government sector.



Source: FFA (2011: 22).

Also subject to ESA 95 since the second series of bilateral agreements with the EU, Switzerland has been constrained to adapt its statistical delimitation criteria.

<sup>73</sup> Eurostat (2013: 14) defines sales as “all payments linked to the volume of output are included, but payments to cover an overall deficit are excluded” and production cost as “the sum of intermediate consumption, compensation of employees, consumption of fixed capital and other taxes on production”.

In a recent report, the Swiss Federal Finance Administration (FFA) develops a decision tree (Figure 5-4), whose merit is to be extremely simple and, at the same time, in total accordance with the European standards.

### *5.1.3 The notion of public deficit and public debt*

Analysing a fiscal constraint, which aims at controlling the levels of *public deficit* and *public debt*, requires clear definitions, firstly, of the term “public” and, secondly, of the accounting notions of “deficit” and “debt”. Following the latter logic, the previous subsection has presented the sectoring principles being in force in the EU. Through the description of these rules, we understand that the allocation to a particular sector ultimately depends on the type of activity and on who controls the unit (FFA, 2011: 21). Now that we are in a position to determine which economic activities belong to the general government, in the sense of the ESA 95, we turn to the second step and enter into the accounting construction of the public sector in order to clarify the European meaning of public deficit and debt. For doing so, we proceed in the same way as previously with the coverage of the public sector and provide a survey of the relevant legal bases.

Likewise the specification of the sectoring rules, the economic sense to be given to the terms “government deficit” and “government debt” is mainly developed through several articles of the ESA 95. As for theirs, Protocol No. 12 and Council Regulation No. 479/2009 only outline the basic definitions of both terms, as well as of “government investment”<sup>74</sup>. More useful, the Regulation completes them with the reference codes of the ESA 95. Art. 1(3 to 5) of the latter legal base makes the following statement:

(3) “*Government deficit (surplus)*” means the net borrowing (net lending) (EDP B.9) of the sector of “general government” (S.13), as defined in ESA 95. The interest comprised in the government deficit is the interest (EDP D.41), as defined in ESA 95.

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<sup>74</sup> Public investment is also specified since Art. 126(3) TFEU provides that, in case of non-compliance of a member state with the criteria, the commission, in its report, should “take into account whether the government deficit exceeds government investment expenditure”.

(4) “Government investment” means the gross fixed capital formation (P.51) of the sector of “general government” (S.13), as defined in ESA 95.

(5) “Government debt” means the total gross debt at nominal value outstanding at the end of the year of the sector of “general government” (S.13), with the exception of those liabilities the corresponding financial assets of which are held by the sector of “general government” (S.13).

*Government debt is constituted by liabilities of general government in the following categories: currency and deposits (AF.2); securities other than shares, excluding financial derivatives (AF.34) and loans (AF.4), as defined in ESA 95.*

Once again, in order to completely grasp the economic scope of these definitions, we obviously need to investigate further the ESA 95. This time, the attention is focused on the accounting principles prescribed in this system. Keep in mind that, rather than describing the methods for recording public bookkeeping entries, we try to highlight the relevant elements allowing the computation of the concerned aggregates.

As stated in Para. 1.61 of the ESA 95, “the [accounting] system is built around a sequence of inter-connected accounts”, which is implemented for each institutional unit. This sequence of accounts is articulated into four main “blocs”, which concretely represent three kinds of accounts: the currents accounts (I and II), the accumulation accounts (III) and the balance sheet (IV). Moreover, each of these groups can be subdivided into further levels of detail. At three degrees of detail, the full sequence is the following:

I. Production account

II. Distribution and use of income accounts

II.1. Primary distribution of income account

II.2. Secondary distribution of income account

II.3. Redistribution of income in kind account

II.4. Use of income account

III. Accumulation accounts

III.1. Capital account

III.2. Financial account

### III.3. Other changes in assets accounts

## IV. Balance sheets

### IV.1. Opening balance sheet

### IV.2. Changes in balance sheet

### IV.3. Closing balance sheet

On the basis of this accounting arrangement and on the above-mentioned law articles, we study firstly the notion of public deficit. As stated in the Council Regulation, the “government deficit” mentioned in the TFEU refers to the balancing item “net borrowing/net lending”, codified B.9. More than just pointing the bookkeeping line, we seek to understand the exact path that leads to it. In this attempt, it is necessary to present the sequence from the beginning.

So, Figure 5-5 shows the European current account. Generally speaking, this first accounting document “deals with the production, generation, distribution and redistribution of income and the use of this income in the form of final consumption” (Para. 1.61 ESA 95). The current account can actually be divided into two sections. Whereas the production account leads to the balancing item B.1n, the net value added, the distribution and use of income accounts, starting from B.1n, ultimately provide the saving (if positive) or the overdraft (if negative). Besides, we note that, in accordance with the initial definition of “government deficit”, the payment of the interest (D.41) appears at the third level of the current account.

More importantly, we observe that putting into perspective the current expenditures and the current revenues leads to the public saving or overdraft (B.8). In other words, it is relevant to underscore that the European definition of the public deficit does not entirely corresponds to the notion presented in Subsection 4.1.3 and developed on the basis of the revisited golden rule. In the latter public accounting plan, the deficit (or surplus) is obtained by balancing only the current account. In consequence, what is referred as the “government deficit” in the ESA 95 may not be directly compared with the notion exposed previously, since it does not convey the same economic sense.

Figure 5-5: The ESA 95 current accounts.

Current Accounts*	
Uses	Resources
<b>P.2 Intermediate consumption</b>	<b>P.1 Output</b>
	P.11 Market Output
	P.12 Output for own final use
	P.13 Other non-market output
<b>B.1g Value added, gross</b>	
<b>K.1 Consumption of fixed capital (+)</b>	<b>B.1g Value added, gross</b>
<b>B.1n Value added, net</b>	
<b>D.1 Compensation of employees</b>	<b>B.1n Value added, net</b>
D.11 Wages and salaries	
D.12 Employers' social contributions	
<b>D.29 Other taxes on production</b>	
<b>D.39 Other subsidies on production, receivable (-)</b>	
<b>B.2 Operating surplus</b>	
	<b>B.2 Operating surplus</b>
	<b>D.2 Taxes on production and imports</b>
	D.21 Taxes on products
	D.29 Other taxes on production
	<b>D.3 Subsidies, payable (-)</b>
	D.31 Subsidies on products, payable
	D.39 Other subsidies on production, payable
<b>D.4 Property income</b>	<b>D.4 Property income</b>
D.41 Interest	D.41 Interest
D.42 Distributed income of corporations	D.42 Distributed income of corporations
D.43 Reinvested earnings on direct foreign investment	D.43 Reinvested earnings on direct foreign investment
D.45 Rent	D.44 Property income attributed to insurance policyholders
	D.45 Rent
<b>B.5 Balance of primary incomes</b>	<b>B.5 Balance of primary incomes</b>
<b>D.5 Current taxes on income, wealth, etc.</b>	<b>D.5 Current taxes on income, wealth, etc.</b>
<b>D.62 Social benefits other than social transfers in kind</b>	
<b>D.7 Other current transfers</b>	<b>D.61 Social contributions</b>
D.71 Net non-life insurance premiums	<b>D.7 Other current transfers</b>
D.73 Current transfers within general government	D.72 Non-life insurance claims
D.74 Current international corporations	D.73 Current transfers within general government
<b>B.6 Disposable income</b>	D.74 Current international corporations
<b>D.631 Social benefits in kind</b>	<b>B.6 Disposable income</b>
D.6311 Social security benefits, reimbursements	
D.6312 Other social security benefits in kind	
D.6313 Social assistance benefits in kind	
<b>B.7 Adjusted disposable income</b>	
<b>P.4 Actual final consumption</b>	<b>B.7 Adjusted disposable income</b>
<b>D.8 Adjustment for the change in net equity of households in pension funds reserves</b>	
<b>B.8 Saving (+) / Overdraft (-)</b>	

\* including the production account and the distribution and use of income accounts

Source: Author's elaboration from information available on the ESA 95 website.

In fact, the calculation of the public deficit, under the ESA 95, requires taking into account the capital account (Figure 5-6). This second document consists in a subdivision of the larger accumulation accounts, which “cover changes in assets and liabilities and changes in net worth” (Para. 1.61 ESA 95). Although, the

sequence of account in the ESA 95 marks a clear distinction between the current (numbered I and II) and the capital account (III.1), the latter begins with the balance item of the former (B.8). From a purely economic perspective, this certain continuity is not without raising some issues (see Chapter 4). Except from this link with the current account and the slightly different presentation, the capital account performs a quite similar function as in the FS model. According to the ESA 95, the final balance of this account provides however the “Net lending (+) / net borrowing (-)” item (B.9), which represents the central figure of public deficit in the context of the European fiscal constraint.

Figure 5-6: The ESA 95 capital account.

Capital Account	
Changes in assets	Changes in liabilities and net worth
	<b>B.8 Saving (+) / Overdraft (-)</b>
	<b>D.9 Capital transfers, receivable</b>
	D.91 Capital taxes
	D.92 Investment grants
	D.99 Other capital transfers
	<b>D.9 Capital transfers, payable (-)</b>
	D.91 Capital taxes
	D.92 Investment grants
	D.99 Other capital transfers
<b>B.10.1 Changes in net worth due to saving and capital transfers</b>	
<b>P.51 Gross fixed capital formation</b>	<b>B.10.1 Changes in net worth due to saving and capital transfers</b>
P.511 Acquisitions less disposals of tangible fixed assets	
P.512 Acquisitions less disposal on intangible fixed assets	
P.513 Additions to the value of non-produced non-financial assets	
<b>K.1 Consumption of fixed capital (-)</b>	
<b>P.52 Changes in inventories</b>	
<b>P.53 Acquisitions less disposal of valuables</b>	
<b>K.2 Acquisitions less disposal of non-produced non-financial assets</b>	
K.21 Acquisitions less disposals of land and other tangible non-produced assets	
K.22 Acquisitions less disposals of intangible non-produced assets	
<b>B.9 Net lending (+) / net borrowing (-)</b>	

Source: Author's elaboration from information available on the ESA 95 website.

Let us now turn to the figure of public debt, which remains to be investigated. For that, the analysis of a third accounting document is necessary, namely the balance sheet (Figure 5-7). Strictly speaking, the full sequence of accounts of the ESA 95 prescribes a division of the balance sheet into three steps: the opening, the yearly changes and the closing. Since our target consists simply in the extraction of the

measurement of public indebtedness, Figure 5-7 ignores the intermediate stage and rather presents the balance sheet in its opening (or closing) form. As far as the composition of this document is concerned, Para. 7.20 to 7.24 of the ESA 95 define and list the types of assets and liabilities. In addition, Annex 7.1 provides deeper information for each category.

Figure 5-7: The ESA 95 balance sheet.

<b>Balance sheet</b>			
<b>Assets</b>		<b>Liabilities</b>	
<i>AN</i>	<i>Non-financial assets</i>	<i>AF</i>	<i>Liabilities</i>
<b>AN.1</b>	<b>Produced assets</b>	<b>AF.2</b>	<b>Currency and deposits</b>
AN.11	Fixed assets	<b>AF.3</b>	<b>Securities other than shares</b>
AN.12	Inventories	AF.33	Securities other than shares, excluding financial derivatives
AN.13	Valuables	AF.34	Financial derivatives
<b>AN.2</b>	<b>Non-produced assets</b>	<b>AF.4</b>	<b>Loans</b>
AN.21	Tangible non-produced assets	AF.41	Short-term
AN.22	Intangible non-produced assets	AF.42	Long-term
<b>AF</b>	<b>Financial assets</b>	<b>AF.5</b>	<b>Shares and other equity</b>
<b>AF.1</b>	<b>Monetary gold and SDRs</b>	<b>AF.6</b>	<b>Insurance technical reserves</b>
<b>AF.2</b>	<b>Currency and deposits</b>	<b>AF.7</b>	<b>Other accounts payable</b>
<b>AF.3</b>	<b>Securities other than shares</b>		
AF.33	Securities other than shares, excluding financial derivatives		
AF.34	Financial derivatives		
<b>AF.4</b>	<b>Loans</b>		
AF.41	Short-term		
AF.42	Long-term		
<b>AF.5</b>	<b>Shares and other equity</b>		
<b>AF.6</b>	<b>Insurance technical reserves</b>		
<b>AF.7</b>	<b>Other accounts receivable</b>	<b>B.90</b>	<b>Net worth</b>

Source: Author's elaboration from information available on the ESA 95 website.

Regarding the calculation of government debt, we note that the ESA 95 does not provide any specific definition, as it does for the deficit (Annex V). Instead, The ESA 95 contains provisions on the valuation rules that govern financial liabilities. We learn for instance that “the stock of the assets and liabilities recorded in the balance sheet is valued at the market price prevailing on the date to which the balance sheet relates” (Para. 7.01). Looking exclusively at the ESA 95, the stock of government debt would be equal to the sum of all liabilities present in the general government balance sheet (AF.2 to AF.7, in the liabilities side of Figure 5-7). However, taking into account the definition stated in the above-mentioned Council Regulation, we understand that the notion of public debt, which prevails in the context of the European fiscal constraint, differs slightly. In fact, the

specification of the relevant components (with their ESA 95 codes) made in the Regulation encompasses only the currency and deposits (AF.2), the securities other than shares (AF.3) and the loans (AF.4). Moreover, the financial derivatives (AF.34) are excluded from the calculation.

#### *5.1.4 The reporting and monitoring rules*

The TFEU designates the Commission as the institutional body in charge of the monitoring “of the development of the budgetary situation and of the stock of government debt” (Art. 126(2)). On the one hand, the achievement of this mandate goes through the respect of a certain number of *reporting rules* beheading to the member states and laid down in Chapter II of the Council Regulation No. 479/2009 (already provided in Regulation No. 3605/93, yet amended in 2005 and 2009). On the other hand, the monitoring power implies a regular qualitative assessment of the fiscal figures produced by the member states. The latter procedure of control is described in Chapter III of the same Regulation (introduced only in Regulation No. 2103/2005).

Regarding firstly the reporting rules, the procedure requires the member states to communicate to the Commission, twice a year, “their planned and actual government deficits and levels of government debt” (Art. 3(1)). The first report is due to 1<sup>st</sup> April, the second to 1<sup>st</sup> October. These reports are transmitted under the form of the so-called “EDP notification tables”. Appendix B presents a sample of the French report of October 2012<sup>75</sup>. In accordance with the Regulation, the EDP notification tables should contain specific data, not only for the current year, but also for the past four budget years. Moreover, Euostat prescribes the following format of presentation:

- Table 1 provides a summary view including: the net borrowing (-) / net lending (+) for the general government and the sub-sectors, the detail of the general government debt, the general government investment expenditure, the interest payable by the general government (reported both with and without interest payments on swaps and financial derivatives), and the GDP.

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<sup>75</sup> The EDP notification tables of each EU member states are made public and are available at: [http://epp.eurostat.ec.europa.eu/portal/page/portal/government\\_finance\\_statistics/excessive\\_deficit/edp\\_notification\\_tables](http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/excessive_deficit/edp_notification_tables).



- Tables 2 (2A, 2B, 2C and 2D) explain, for each sub-sector, the transition from its working balance to its recorded deficit or surplus. The working balances are, on the one hand, completed with operations that are off-budget, but that are considered in national accounts as part of government operations and, on the other hand, corrected for operations that impact them whilst are considered as financial transactions in national accounts without impact on the ESA deficit.
- Tables 3 (3A, 3B, 3C, 3D, 3E) explain the link between the annual deficit or surplus and the variation in public indebtedness for the same year. For instance, these tables take into account the borrowing needs due to the acquisitions of financial assets.
- Table 4 finally provides complementary data, such as: the stock in trade credit payable by government, the amount outstanding in the government debt from the financing of public undertakings, the extent and the reasons in case of substantial differences between the face value and the present value of government debt, and the Gross National Income (GNI).

Besides monitoring, on the basis of the notification tables, the compliance with the fiscal criteria, the Commission is also entrusted with the assessment of the quality of the data reported by the member states<sup>76</sup>. As specified in Art. 8(1) of the Council Regulation, the quality of the data means “the compliance with accounting rules, completeness, reliability, timeliness, and consistency of the statistical data”. In order to make this control possible, the member states have to provide the Commission with “the relevant statistical information” (Art. 8(2)), which refers to (1) data from national accounts, (2) inventories, (3) EDP notification tables, and (4) additional questionnaires and clarification related to the notifications. The results of these qualitative assessments should be regularly reported to the European Parliament and to the Council (Art. 8(3)).

Also in the purpose of facilitating the dialogue between the Commission and the member states, and especially their statistical authorities, the former should undertake regular “dialogue visits” (Art. 11(1)). If it exists significant risks or

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<sup>76</sup> With the introduction of the Six-Pack, the manipulation of statistics may lead to financial sanctions (see Section 5.4).

problems with the quality of the reported data<sup>77</sup>, the Commission can further carry out “methodological visits”, which consists in a deeper analysis of the accounts of all government units at each level and ultimately leads to a report to the Economic and Financial Committee.

## **5.2 The original Stability and Growth Pact**

In the mid-1990s, with the concrete formation of the monetary union approaching, some EU member states started to question the ability of the Maastricht fiscal constraint – as described in the previous section – to maintain efficiently fiscal discipline within the EMU. Although the Treaty provided corrective and sanction mechanisms, it seems indeed that the risk of being excluded from the euro area constituted, at the convergence stage (1992-1998), the main threat for the candidate states (Schuknecht *et al.*, 2011: 9). For this reason, it was feared that, once having joined the Eurozone, fiscal discipline would be relaxed and the effort consented by the governments since 1992 would be cancelled out. In order to avoid this scenario, it appeared that the original European budget constraint required additional provisions. As reported by Langenus (2005: 68), three issues were particularly debated. First of all, given the objective of safeguarding the functioning of the automatic stabilisers, “the deficit level of 3 per cent of GDP had to be presented much more explicitly as an upper limit [...], rather than as an aim for fiscal policy”. Secondly, the deterrent effect of the sanctions should be reinforced and made less dependent on the Council’s decisions. In other words, on the one hand, the amount of the fines needed to be discussed and, on the other hand, the EDP needed to be triggered on a more automatic basis. Remember finally that the definition of the “exceptional circumstances”, in which the threshold of 3 per cent of deficit could be exceeded, was not specified nor in the TFEU, neither in the surrounding legal texts. This constituted the third main issue, which needed to be tackled. It is in this context that the German government submitted in 1995 the first proposals calling for several adjustments of the existing fiscal rule. After a long debate, a compromise, named the Stability and

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<sup>77</sup> Art. 11b(3) of the Regulation specifies what is considered as situations of “significant risks or problems”.

Growth Pact (SGP), was reached in December 1996 at the Dublin European Summit.

Formally, the initial SGP consists in three legal acts: the Resolution of the European Council on the Stability and Growth Pact, the Council Regulation No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (entered into force on 1<sup>st</sup> July 1998), and the Council Regulation No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (entered into force on 1<sup>st</sup> January 1999). While the regulations constitute respectively the preventive and corrective arms of the Pact, the resolution provides the political guidelines for the implementation of the SGP and specifies the duties falling to the member states, the Commission and the Council. Similarly to the description provided by Langenus (2005: 68-70), our presentation of this second institutional arrangement, which overlaps the original Maastricht criteria, is divided into three subsections referring each to the above-mentioned main issues. To begin with, we describe the preventive mechanism (Subsection 5.2.1). Then, we expose the adjustments brought about the definition of the notion of excessive public deficit (Subsection 5.2.2). Last but not least, Subsection 5.2.3 highlights the new components of the correction and sanction mechanisms.

### *5.2.1 The preventive arm*

In order to avoid situations of excessive deficit, the SGP contains a so-called “preventive” mechanism. Laid down in the Council Regulation No. 1466/97, the latter institutional instrument provides that the participating member states submit, on an annual basis, individual “stability programmes”<sup>78</sup> (Art. 3(1)), which consists in a sketch of the development of public finances for the forthcoming years. Formally, a stability programme must provide annual figures covering the preceding and current year, as well as the following three years (Art. 3(3)). While these documents are then subject to Commission’s assessment, the Council is ultimately in charge of controlling their content, as well as their actual implementation. Thereby, the stability programmes come within the framework of

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<sup>78</sup> The non-participating member states must submit a slightly different document called “convergence programmes”, whose legal base is also the Council Regulation No. 1466/97.

the multilateral surveillance outlined in the Treaty (Art. 121 TFEU). Before looking in greater details at the surveillance procedure, the content of these programmes must be further studied since it introduces a key component: the medium-term objective for the budgetary position (MTO).

As pointed out in introduction of the current section, one particularly important target of the SGP was to specify the interpretation of the 3 per cent deficit ceiling. Whereas the Maastricht criteria defined it as an aim *per se*, the SGP should present it as an upper limit, so as making the member states able to deal with economic fluctuations without breaching the tolerated threshold. The content of the stability programmes, prescribed in the Regulation, goes in that direction. The member states have indeed to set a *medium-term budgetary objective*, which should be “*close to balance or in surplus*”. If not achieved yet, the member state must describe its adjustment path towards it, as well as the expected path of its ratio of indebtedness<sup>79</sup>. Although the constraint seems more stringent since the fiscal target is, at least, approaching the balance – instead of 3 per cent of GDP – one must note a disturbing shortage in the definitions of both notions of “medium-term” and of “close to balance”. In clear, such a lack of precision means that the member states enjoy a certain room for manoeuvre in the way they interpret the rule and, as developed in Chapter 4, this tends to weakens the constraint.

The Council Regulation No. 1466/97 not only stipulates the content of the stability programmes, but also describes the monitoring procedure, which allows the control of the compliance of the member states with the rule and, if necessary, the correction of the misbehaviours in a timely manner. The procedure starts thus with the assessments of the Commission and EFC. Based on those, the Council particularly “examine[s] whether the medium-term budget objective in the

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<sup>79</sup> Formally, Art. 3(2) states that the stability programmes should contain the following information: “(a) the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective for the general government surplus/deficit and the expected path of the general government debt ratio; (b) the main assumptions about expected economic developments and important economic variables which are relevant to the realization of the stability programme such as government investment expenditure, real gross domestic product (GDP) growth, employment and inflation; (c) a description of budgetary and other economic policy measures being taken and/or proposed to achieve the objectives of the programme, and, in the case of the main budgetary measures, an assessment of their quantitative effects on the budget; (d) an analysis of how changes in the main economic assumptions would affect the budgetary and debt position”.

stability programme provides for a safety margin to ensure the avoidance of an excessive deficit, whether the economic assumptions on which the programme is based are realistic and whether the measures being taken and/or proposed are sufficient to achieve the targeted adjustment path towards the medium-term budgetary objective” (Art. 5(1)). This examination leads, at the latest two months after the submission of the programme, to an opinion of the Council. Where the Council deems the programme unsatisfactory (for instance, because of unrealistic economic assumptions or insufficient policy measures), it “invite[s] the member state concerned to adjust its programme” (Art. 5(2)). In addition to the approbation of the programmes proposed by the member states, the Council also monitors their implementation. Assisted once again by the Commission and the EFC, the Council investigates the potential divergences between the budgetary position and the medium-term objective and, between the budgetary position and the adjustment path. In case of significant divergence, the Council formulates a recommendation to the concerned member states. Similarly to the initial correction procedure (Subsection 5.1.1), the Council may further make the recommendation public if the divergences are persisting. This mechanism, which does not encompass additional sanctions in case of persistent diverging MTO or adjustment path, is sometimes referred as the “early warning” procedure.

### *5.2.2 The revised notion of excessive deficit*

As our description of the original Maastricht fiscal rule has revealed, the respect of the deficit and debt limit can be relaxed under certain conditions, which nor the TFEU, neither the surrounding legal texts, precisely define. So, a deficit ratio greater than 3 per cent can be tolerated as far as (1) it has “declined substantially” and is “close to the reference value” or (2) it is “exceptional and temporary”. Regarding the debt ratio, it must be “sufficiently diminishing and approaching the reference value at a satisfactory path” (see Subsection 5.1.1). This definitional looseness left ample scope for interpretation. Attempting to fulfil this deficiency, the Regulation No. 1467/97 specifies the definition of “exceptional and temporary”, which contributes to clarify the notion of “excessive deficit”.

Firstly, Art. 2(1) of the regulation stipulates that a public deficit, greater than 3 per cent of GDP, may be labelled “exceptional and temporary” when “resulting from an unusual event outside the control of the member state concerned and which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn”. Far from removing all sources of potential confusion, the definition is further completed with a more detailed specification of the terms “temporary” and “exceptional”. Thereby, we learn that the excess is considered “temporary” in so far the budgetary forecasts show that the excess will be corrected as soon as the unusual event of the economic slowdown ends. Furthermore, if the excess is attributable to an “exceptional” economic situation, the latter should record, at least an annual fall of real GDP of 2 per cent (Art. 2(2)). Nevertheless, the strictness of this limit is tempered by the following paragraph of the regulation. It indeed prescribes that the “abruptness of the downturn”, as well as the “accumulated loss of output relative to past trends”, shall be taken into account in Council’s decision (Art. 2(3)). However, according to the Resolution of the European Council, this escape clause can be only invoked in case of an annual fall of GDP of at least 0.75 per cent. In clear, the SGP stipulates that, in case of violation of the 3 per cent threshold, a member state must face an economic slowdown of at least 0.75 per cent of GDP for avoiding the excessive deficit procedure.

### *5.2.3 The corrective arm*

As it was initially provided in the “first version” of the European fiscal constraint, the SGP reaffirms, in the Council Regulation No. 1467/97, the existence of a mechanism of correction and, ultimately, a procedure of sanction. In the context of the SGP, this institutional arrangement is referred as the corrective arm, supposed to follow the above-mentioned preventive arm, when a member state still records an excessive deficit. As far as the correction mechanism is concerned, the main contribution of the SGP lies in the setting of a clear time schedule regarding the successive correction steps provided in the TFEU. Whereas the initial Maastricht budget constraint defined the sequence, the SGP specifies its timing, so as to make the process leading to sanctions more automatic. Regarding

the sanctioning side of the corrective arm, the Regulation No. 1467/97 completes some of the practical holes left by the TFEU.

Figure 5-8 illustrates graphically the process provided by the Council Regulation No. 1467/97 (Art. 1 to Art. 7). In accordance with the initial design of the European fiscal rule (see Subsection 5.1.1 and Figure 5-3), the procedure begins with the assessment of the excessive deficit, continues with a mechanism of correction, and may go until the imposition of sanctions. Although this whole sequence was already present in the TFEU, its exact timing remained undefined and, in consequence, opened to variations. Let us thus describe further this intake of the Pact.

As presented in Figure 5-8, we assume that a member state records an excessive deficit in year  $n-1$ . Pursuant to the Regulation prescribing the reporting rules (see Subsection 5.1.4), the actual fiscal figures of the year  $n-1$  have to be transmitted to the Commission by 1<sup>st</sup> October  $n$ <sup>80</sup>. Considering that a situation of excessive deficit exists, the Commission shall address an opinion, as well as a recommendation, to the Council. Before transferring the case, the Commission must wait on the opinion of the EFC. The EFC shall act within two weeks (Art. 3(1)). At the earliest, the Council, whose role consists firstly in confirming the existence of the excessive deficit, starts the investigation in mid-October  $n$  and has three months (counted from the reporting dates) to make its decision (Art. 3(3)). If it confirms the excessive deficit (at the latest, on 1<sup>st</sup> January), the Council shall simultaneously make recommendations to the concerned member state. From this moment, the member state must take “effective action” within four months at the most (Art. 3(4)). Moreover, the Council shall also establish a deadline for the correction of the excessive deficit. The Regulation provides that the member state has up to one year to comply, “*unless there are special circumstances*” (Art. 3(4)). Put differently, the excessive deficit occurring in the fiscal year  $n-1$  should be corrected by the end of  $n+1$ . We note however that the above-mentioned “special circumstances” are not specified, which involves, in consequence, that the one year deadline may lengthen considerably. Contrasting

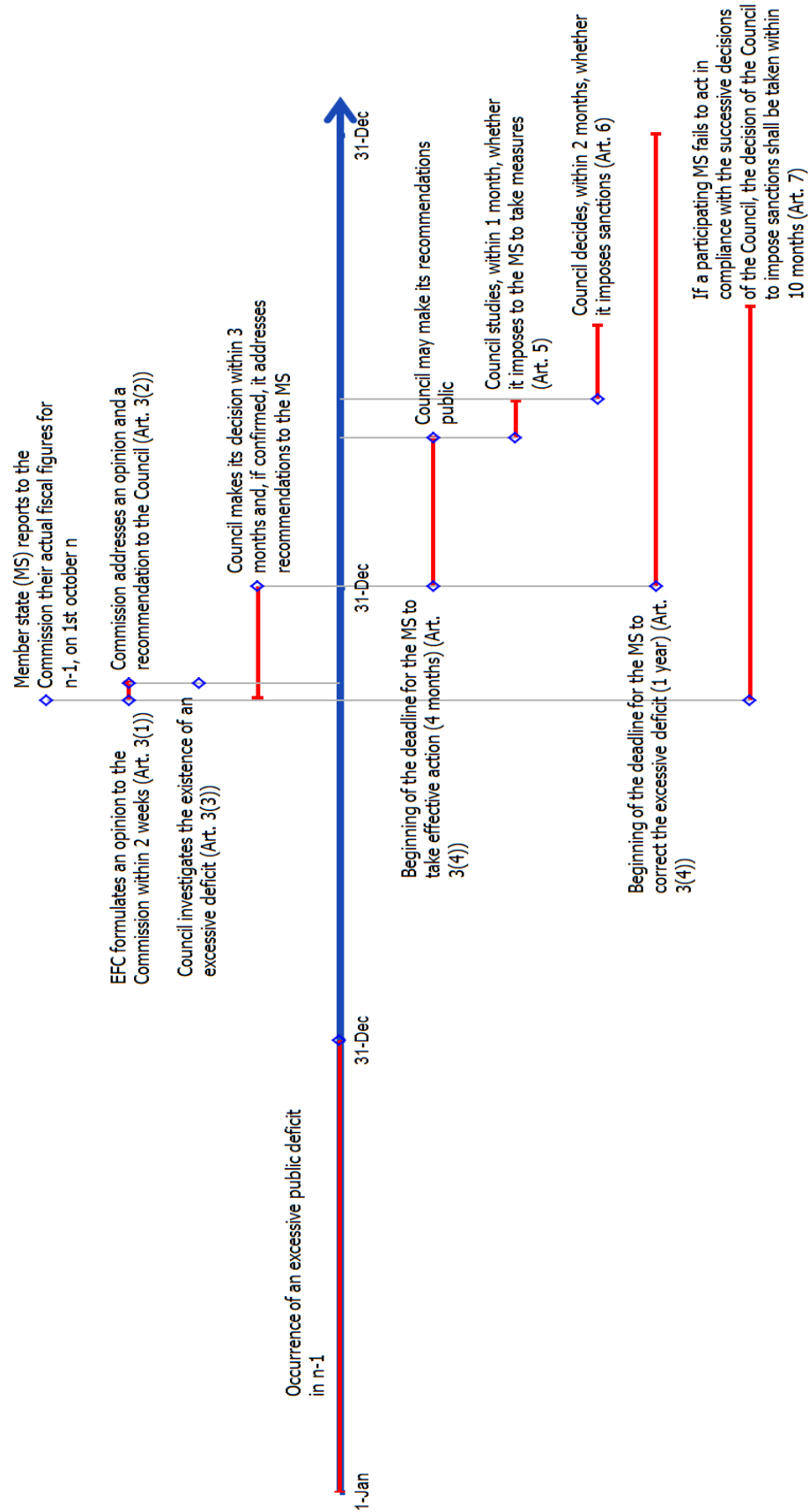
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<sup>80</sup> When the SGP entered into force, the actual government deficit for year  $n-1$  had to be reported by the 1<sup>st</sup> September  $n$  (Art. 4(3) Council Regulation No. 3605/93).

with this institutional weakness, the SGP provides additional instruments designed to intensify the pressure on the concerned member state. Thereby, at the end of the four months period, the Council may decide to make its recommendation public, if no effective action has been undertaken. It has then one month to “give notice to the participating member state to take measures for the deficit reduction” (Art. 5). Finally, in cases where the member state still fails to take into consideration the successive decisions of the Council, the latter may decide, within two months, to impose sanctions (Art. 6). So, as summarized by Art. 7 of the regulation, the non-mitigation of excessive deficit leads to sanctions within ten months following the reporting date. Taking strictly into account the provisions of the SGP, we understand that a member state, who breaches the fiscal rule in fiscal year  $n-1$  and ignores the successive decisions of the Council, risks to face sanctions in August  $n+1$ . Note however that the whole procedure may be held in abeyance (for an undetermined period of time) if (1) the concerned member state acts in compliance with the initial Council’s recommendation or if (2) it implements the measures dictated by the Council (Art. 9(1)).



Figure 5-8: Time schedule of the correction mechanism.



Besides setting the time schedule leading to correction mechanism, the SGP, in the same regulation, specifies the modalities of implementation of the arsenal of sanctions prescribed in the founding Treaty. Whereas the TFEU only provides the exhaustive list of the sanctioning measures that the Council may apply (see Art. 126(11) TFEU and Subsection 5.1.1), the Council Regulation No. 1467/97 defines the implementation order. To begin with, the Regulation stipulates that the sanction consisting in a non-interest-bearing deposit shall be required, as a rule. From this point, the Council may freely add to this measure any of the other possible sanctions, except from the imposition of fines (Art. 11). Concretely, the member state can potentially be constraint to publish additional information before issuing bonds and securities and/or see the European Investment Bank reconsider its lending policy towards it.

Finally, the Regulation lays down the rule defining the size of the non-remunerated deposits when it results from non-compliance with the deficit criterion. The amount is the sum of a fixed and variable component. The fixed part shall correspond to 0.2 per cent of GDP. The variable one is equal to “one tenth of the difference between the deficit as percentage of GDP in the preceding year and the reference value of 3 per cent of GDP” (Art. 12(1)). For instance, if a member states records a deficit-to-GDP ratio of 4 per cent, the variable component would amount to 0.1 per cent of GDP (1/10 of 1 per cent). Each following year, the Council may intensify the “pressure” by imposing the payment of additional deposits. Those are calculated according to the rule of the variable component (Art. 12(2)). However, any single deposit cannot exceed 0.5 per cent of GDP (Art. 12(3)). After two years, the Council shall decide to convert the deposit into a non-refundable fine (Art. 13), which shall be redistributed among the participating member states according to an allocation key defined in Art. 16.

### **5.3 The revised Stability and Growth Pact**

A deep understanding of any institutional arrangement requires often placing its evolution into its context. The European construction and, more particularly, its instrument of fiscal discipline, are no exception. Thereby, it is meaningful to

recall that the initial budget constraint, laid down in the Maastricht Treaty, was designed in a purpose of fiscal convergence, while the introduction of the SGP accompanied the entrance into force of the monetary union. Similarly, the context in which the 2005 reform of the SGP took place is not only worth to have in mind, but also contributes to explain the rationale behind its content.

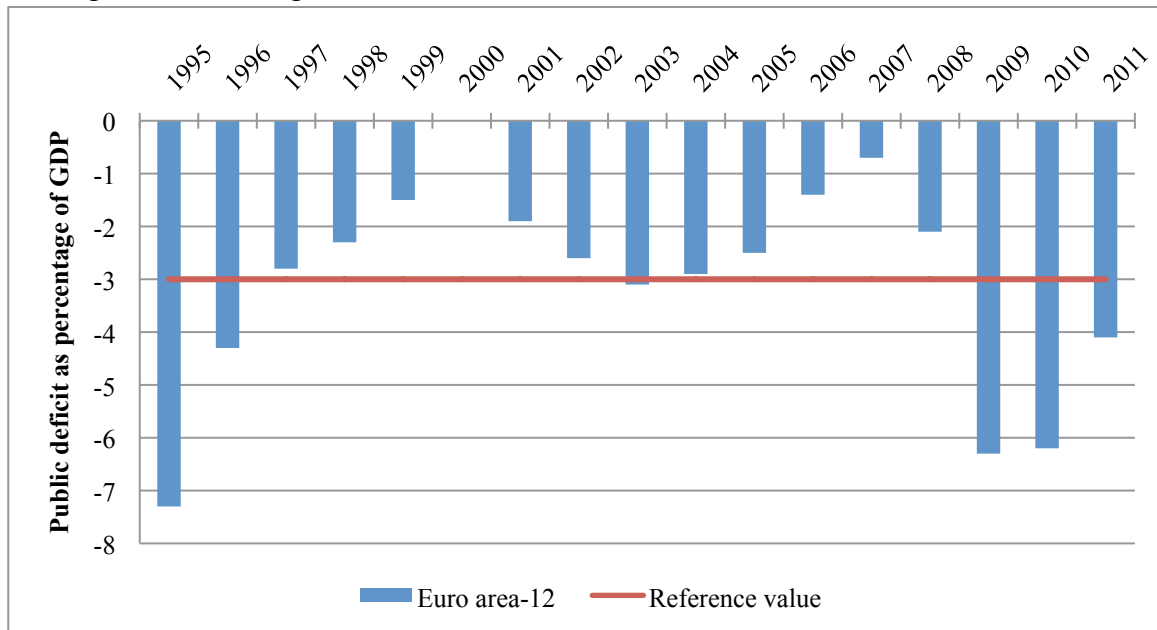
Only a few years after its full implementation in 1999, the initial SGP started to be vehemently questioned. In parallel with the critics addressed by academic researchers<sup>81</sup>, several factors and events affected seriously the credibility of the Pact and led to its revision in 2005<sup>82</sup>. Leaving aside for now the institutional shortages inherent to the initial SGP, we note that it is the combination of two phenomena that precipitated the original SGP to its failure, i.e. to its reform. On the one hand, it appeared that, soon after the introduction of the single currency, fiscal discipline was widely loosened. Looking at the evolution of the deficit-to-GDP ratios of the member states, we notice indeed that, while the budgetary positions had improved considerably during the convergence stage (1992-1997), the fiscal behaviours within the EMU changed significantly in the following years (Schuknecht *et al.*, 2011: 10). Given that, between 1997 and 2000, “more than half of the deficit reduction [...] is attributable to the favourable economic environment” (Langenus, 2005: 72), Figure 5-9 illustrates the relaxation of the fiscal policies only partially. However, since 2001, when the economic cycle turned, the deterioration of fiscal balances became obvious. In 2003, the average deficit-to-GDP ratio in the euro area-12 (EA-12) reached a higher level than in 1997. In consequence, the progress towards sound public finances, made between 1992 and 1997, was not only dangerously compromised, but also turned out to be insufficient in the preceding high-growth years (Diebalek *et al.*, 2006: 79). In passing, it is worth noting that the introduction of the SGP, which was supposed to strengthen the European fiscal rule, was nonetheless marked by a significant relaxation of the fiscal discipline.

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<sup>81</sup> The scepticism of the academic world about the SPG actually dates back from the very entrance into force of the Pact. See for instance, Buti *et al.* (1998), Buti *et al.* (2003), Eichengreen and Wyplosz (1998) or Herzog (2004).

<sup>82</sup> Langenus (2005) emphasises four factors explaining the lack of success of the SGP: (1) a hiatus in the regulatory framework, (2) over-optimistic economic growth expectations, (3) the non-compelling corrective arm and (4) the existence of assessment difficulties.

Figure 5-9: Average deficit-to-GDP ratio of euro area-12.



Source: Author's elaboration from data presented in Appendix C.

Directly related to the above-mentioned evolution, the second phenomenon, which forced the European Commission to formulate a reform proposal in 2004, concerned the ineffectiveness of the corrective arm of the SPG. In fact, the economic turmoil that occurred in Europe at the turn of the century had soon an impact on the public deficits of the EMU participants and constituted a first delicate implementation test for the Pact. Since 2001 already, several countries breached indeed the reference value of 3 per cent. Among those, we find not only Greece and Portugal, but also Germany, France and Italy, the three largest EU economies in terms of GDP. Following strictly the provisions laid down in the Pact, these fiscal situations should have triggered the opening of excessive deficit procedures, leading potentially to imposing sanctions according to the time schedule presented in Figure 5-8. However, despite the initial will of the SGP designers to increase the automatic triggering of the sanction mechanism, one must realise that the formal decisions remained *de facto* in the hands of the Council (constituted of one minister of each member states), which naturally raised some doubts over the enforceability of the European fiscal constraint. For instance, “in deciding on whether to impose sanctions, member states which are not threatened by sanctions may take into account the possibility that they could in the future exceed deficit limits themselves” (Diebalek, 2006: 86) and therefore,

take the decisions, which would secure the support of their colleagues if necessary. Unfortunately for the credibility of the rule, the existence of these political incentives was quickly confirmed by several decisions of the Council that ignored the Commission's recommendations. For instance, in February 2002, contrasting with Commission's recommendation, the Council decided not to address any early warning to Germany and Portugal. Worst, in November 2003, while the Commission recommended moving to the next steps of the EDP for France and Germany by giving them notice to take measures, the Council failed again to act accordingly (Langenus, 2003: 76). Confronted with the clear unwillingness of the Council and some member states to implement properly the Pact, the Commission initiated the first revision of the SGP<sup>83</sup>.

In short, this contextual sketching shows that, whereas the introduction of the initial SGP found its justification in the desire of guaranteeing fiscal discipline, the revised version of these Council Regulations has been mostly driven by purely political concerns. Indeed, under the pressure of some member states, in particular Germany and France, who considered that the SGP was lacking of flexibility and, for this reason, appeared to be unenforceable, the two Council Regulations were amended.

Given that the latter amendment constitutes only an intermediary step in the evolution of the European fiscal constraint (the two legal text are further amended in 2011 with the implementation of the "Six-Pack"), we simply highlight the main features of this "new" Pact, without entering into greater details. Table 5-3 gives thus an overview of the key modifications introduced by the 2005 reform<sup>84</sup>. Generally speaking, we note that the reform tends to relax the fiscal rule under many aspects. The more flexible definition of the MTOs, the introduction of additional loopholes in the procedure, the absence of greater incentives for improving the enforceability, or the general extension of the deadlines contribute to make the fiscal constraint softer. Observing in retrospect this "step backward"

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<sup>83</sup> Diebalek *et al.* (2006: 79) points out that the conflict over the correct interpretation and implementation of the SGP opposed, not only the Commission to the Council (the EMU member states), but also the member states themselves, where the small countries had a stricter interpretation of fiscal discipline than large ones.

<sup>84</sup> Formally, the 2005 amendment consists in only one insertion (Art. 2a) and four modifications of previously existing articles (Art. 3(2), Art. 5, Art. 7(2), Art. 9).

in the achievement of fiscal discipline, Schuknecht *et al.* (2011: 10) characterize the first nine years of the euro (1999-2007) “as “wasted good times” during which the foundations were laid for the present crisis in EMU”.

Table 5-3: *Main changes brought by the first reform in 2005.*

	SGP 1997	SGP 2005
	Council Regulation No. 1466/97	Council Regulation No. 1055/2005
Preventive arm	<i>Medium-term budgetary objective (MTO)</i>	
	Uniformly defined	Country-specific MTOs
	"Close to balance of in surplus" (Art. 3(2))	"Between -1% of GDP and balance or surplus, in cyclically adjusted terms, net on one-off and temporary measures" (Art. 2a) depending on economic variables (level of indebtedness, potential economic growth) and prospective demographic changes (population aging)
		Revised every four years or in case of major structural reform (Art. 2a)
	<i>Adjustment path</i>	
		Benchmark for annual improvement in the budget balance of 0.5% of GDP
		"A higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times" (Art. 5(1))
Corrective arm		Temporary deviation from the adjustment path may be tolerated when resulting of "major structural reforms" (Art. 5(1))
	Examined by the Council within two months from the submission of the programme (Art. 5(2))	Examined by the Council within three months from the submission of the programme (Art. 5(2))
	Council Regulation No. 1467/97	Council Regulation No. 1056/2005
	<i>Definition of "exceptional circumstances"</i>	
	Economic slowdown of at least 0.75% of GDP (Art. 2(2) and(3))	"Negative annual GDP volume growth rate" or "very low annual GDP volume growth relative to its potential" (Art. 2(2))
	<i>List of "other relevant factors" (Art. 126(3) TFEU)</i>	
		"Potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda, policies to foster research and development and innovation [...] fiscal consolidation efforts in "good times", debt sustainability, public investment and the overall quality of public finances [...] efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity" (Art. 2 (3)) and "the implementation of pension reforms" (Art. 2(5))
	<i>Deadlines</i>	
		General extension of the deadlines Additional "exit doors" in the procedure

### 5.4 The “Six-Pack”

Entered into force on 13<sup>th</sup> December 2011, the latest reform of the SGP, referred to as the “Six-Pack”, must be inserted in the context of the global financial crisis and the severe worldwide economic recession that has followed.

Confronted, from September 2008, to the increasing liquidity problems incurred by their financial institutions, many governments, among them the Eurozone member states, had to take measures to ensure the stability of the financial sector, in a first step, and to support the economic activity, in a second step<sup>85</sup>. These several public emergency interventions, designed to mitigate the impact of the crisis and its propagation, came however at a considerable fiscal price. Summed with the fiscal consequences of the profound economic downturn, public finances suffered from a significant deterioration. In the euro area (EA-17), between 2007 and 2010, the average deficit-to-GDP ratio increased by 5.5 percentage points. In same time period, the average debt-to-GDP ratio increased by 19.4 percentage points (Table 5-4).

Table 5-4: *The public deficit and debt ratios in the euro area, 2006-2011.*

	Deficit-to-GDP ratios						Debt-to-GDP ratios					
	2006	2007	2008	2009	2010	2011	2006	2007	2008	2009	2010	2011
Belgium	0.4	-0.1	-1	-5.5	-3.8	-3.7	88	84	89.2	95.7	95.5	97.8
Germany	-1.6	0.2	-0.1	-3.1	-4.1	-0.8	68	65.2	66.8	74.5	82.5	80.5
Estonia	2.5	2.4	-2.9	-2	0.2	1.1	4.4	3.7	4.5	7.2	6.7	6.1
Ireland	2.9	0.1	-7.4	-13.9	-30.9	-13.4	24.6	25	44.5	64.9	92.2	106.4
Greece	-5.7	-6.5	-9.8	-15.6	-10.7	-9.4	107.5	107.2	112.9	129.7	148.3	170.6
Spain	2.4	1.9	-4.5	-11.2	-9.7	-9.4	39.7	36.3	40.2	53.9	61.5	69.3
France	-2.3	-2.7	-3.3	-7.5	-7.1	-5.2	64	64.2	68.2	79.2	82.3	86
Italy	-3.4	-1.6	-2.7	-5.4	-4.5	-3.9	106.3	103.3	106.1	116.4	119.2	120.7
Cyprus	-1.2	3.5	0.9	-6.1	-5.3	-6.3	64.7	58.8	48.9	58.5	61.3	71.1
Luxembourg	1.4	3.7	3.2	-0.8	-0.8	-0.3	6.7	6.7	14.4	15.3	19.2	18.3
Malta	-2.8	-2.3	-4.6	-3.9	-3.6	-2.7	64	61.9	62	67.6	68.3	70.9
Netherlands	0.5	0.2	0.5	-5.6	-5.1	-4.5	47.4	45.3	58.5	60.8	63.1	65.5
Austria	-1.5	-0.9	-0.9	-4.1	-4.5	-2.5	62.3	60.2	63.8	69.2	72	72.4
Portugal	-4.6	-3.1	-3.6	-10.2	-9.8	-4.4	69.4	68.4	71.7	83.2	93.5	108.1
Slovenia	-1.4	0	-1.9	-6	-5.7	-6.4	26.4	23.1	22	35	38.6	46.9
Slovakia	-3.2	-1.8	-2.1	-8	-7.7	-4.9	30.5	29.6	27.9	35.6	41	43.3
Finland	4.2	5.3	4.4	-2.5	-2.5	-0.6	39.6	35.2	33.9	43.5	48.6	49
<b>Euro area-17</b>	<b>-1.4</b>	<b>-0.7</b>	<b>-2.1</b>	<b>-6.3</b>	<b>-6.2</b>	<b>-4.1</b>	<b>68.7</b>	<b>66.4</b>	<b>70.2</b>	<b>80</b>	<b>85.6</b>	<b>88.1</b>
<b>Euro area-12</b>	<b>-1.4</b>	<b>-0.7</b>	<b>-2.1</b>	<b>-6.3</b>	<b>-6.2</b>	<b>-4.1</b>	<b>69.2</b>	<b>66.9</b>	<b>70.9</b>	<b>80.6</b>	<b>86.3</b>	<b>88.8</b>

Source: Author's elaboration from data presented in Appendices C and D.

<sup>85</sup> For a deeper analysis of the range of measures adopted since 2008 by the governments, see Attinasi (2010: 12-21), who examines how the Euro area countries responded to the *financial crisis*, and Afonso *et al.* (2010: 22-34), who concentrate on the fiscal response to the *economic crisis* that followed.

Moreover, one must note that, apart from Estonia, Luxembourg and Finland, whose deficit ratios remained below the reference value, all other member states breached the threshold of 3 per cent. Besides showing the limit of the European mechanism of fiscal surveillance, this observation denotes clearly that “many euro area countries have exploited the maximum degree of flexibility offered by the Stability and Growth Pact in designing their national responses to the economic crisis and allowing for higher budget deficits” (van Riet, 2010: 9). In other words, this implies that “the agreed increase in deficits above the reference value represented a *de facto* suspension of the requirements laid down in the SGP” (Schuknecht *et al.*, 2011: 12). In addition to the failure of the preventive arm of the SGP, the euro area general fiscal stance raised serious concerns regarding its long-term sustainability<sup>86</sup>.

Aware of the malfunctioning of its fiscal discipline instrument, as well as of the risks related to the debt dynamics, the EU initiated, in March 2010, a process of reforms, whose first achievement consists in the implementation of the Six-Pack (Catania, 2011: 1). As its name suggests, this institutional arrangement is formed by six legislative acts: five Regulations and one Directive. Schematically, the institutional scope of the Six-Pack is quadruple. Firstly, the Six-Pack, succeeding to the 2005 reform, constitutes the third amendment of the SGP and endows the latter with a detailed system of sanction intended especially for the Eurogroup member states. Secondly, it introduces a set of rules for the prevention and correction of macroeconomic imbalances. Thirdly, the Six-Pack, in its Directive, makes a first move towards a standardisation of the national fiscal frameworks and constraints. Last but not least, it marks the establishment of the EU policy-making calendar, the so-called “European Semester”.

Before looking closer at these several legal bases, one must highlight two major procedural reforms, which are omnipresent in all provisions implemented by the Six-Pack: the introduction of the *reversed qualified majority* as voting rule, and the greater *implication of the European Parliament* in the several procedures, referred to as the “economic dialogue”. As far as the reinforcement of the

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<sup>86</sup> See for instance Attinasi *et al.* (2010).



cooperation between the European institutions is concerned, each Regulation of the Six-Pack contains one article dedicated to the issue<sup>87</sup>. Each of these articles are formulated in the following manner:

*In order to enhance the dialogue between the institutions of the Union, in particular the European Parliament, the Council and the Commission, and to ensure greater transparency and accountability, the competent committee of the European Parliament may invite the President of the Council, the Commission and, where appropriate, the President of the European Council or the President of the Eurogroup to appear before the committee to discuss decisions taken.*

The objects of these discussions are further specified in each Regulation but encompass all fundamental adoptions of positions, from the imposition of any type of sanctions, to the decisions taken in the framework of the mutual surveillance or the correction of macroeconomic imbalances.

Since it changes deeply the way the Council approves (or rejects) the recommendations of the Commission, the new voting rule provided, under certain circumstances, by the Six-Pack, deserves also some additional explanations. Concerning mainly the decisions dealing with the imposition of sanctions, the system of “reversed qualified majority” has been imagined in order to increase the *automaticity* of the sanction and warning mechanisms. Whereas the Council used to decide, by the qualified majority whether to accept or not a Commission’s recommendation (see Subsection 5.1.1), the decisions are now deemed to be adopted by the Council, *unless* it decides, by a qualified majority, to reject the latter<sup>88</sup>. In addition, where the reversed qualified majority is not explicitly required, the Six-Pack specifies that the Council is expected, as a rule, to follow the Commission’s recommendations. Otherwise, the Council should expose publicly its diverging position (Art. 2-ab(2) Regulation No. 1175/2011 and Art. 2a(1) Regulation No. 1177/2011).

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<sup>87</sup> Art. 3 in Regulation No. 1173/2011; Art. 6 Regulation No. 1174/2011; Art. 2-ab Regulation No. 1175/2011; Art. 14 Regulation No. 1176/2011, and Art. 2a Regulation No. 1177/2011.

<sup>88</sup> As it was already the case before the introduction of the Six-Pack, the Council acts on measures of sanction without taking into account the vote of the concerned member state.

Keeping in mind these two general reforms, let us develop in greater details the concrete content of the Six-Pack and point out the new features introduced by this set of legal acts.

#### *5.4.1 The European Semester*

Contrary to the other changes brought by the Six-Pack, the legal basis of the European Semester is not laid down in a distinct legal act, but is rather included in the Regulation No. 1175/2011 mainly dedicated to the fiscal preventive arm. Its role in the European set of fiscal instrument is not less relevant, since it marks the beginning of a EU fiscal policy-making calendar, which aims at introducing an *ex ante* control over member states' macroeconomic situation, programmes of reforms and, stability and convergence programmes.

Launched for the first time in January 2011 (before the adoption of the Six-Pack), The European Semester ran initially in the framework of the Europe 2020 strategy. It consists in a cycle of economic governance, which shall include (Art. 2-a(2)):

- Board economic guidelines formulated by the Council, on a recommendation of the Commission;
- Employment guidelines, formulated by the Council;
- Member states' Stability (or Convergence) Programmes;
- Member states' National Reform Programmes (NRPs)
- Commission's Alert mechanism report (see Subsection 5.4.3).

Further defined in 2013 within "Two-Pack" reform and the introduction of budgetary timeline, the detailed schedule of the European Semester is presented in Section 5.5.

#### *5.4.2 The last formal reform of the SGP*

The second institutional aspect of the Six-Pack consists formally in a new reform of the SGP. Succeeding to the controversial 2005 amendment (see Section 5.3), the Six-Pack introduces a third version of both Council Regulations forming the Pact. The Regulation on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies is thus amended by *Regulation No. 1175/2011*, while the Regulation on speeding up and

clarifying the implementation of the excessive deficit procedure is replaced by *Regulation No. 1177/2011*. In addition to those acts, the 2011 reform adds another legal base to the institutional arrangement, which is directly related to the functioning of the SGP, but applied exclusively to member states whose currency is the euro. It is named: *Regulation No. 1173/2011 on the effective enforcement of budgetary surveillance in the euro area*. The content of this new Regulation is especially interesting, since it specifies the sanctions to be imposed, not only in the context of the corrective arm, but also in the framework of the preventive arm, as well as in case of manipulation of statistics.

#### *The preventive arm*

To begin with, we focus on the preventive arm and concentrate our attention on the new characteristics brought by the Six-Pack to this instrument.

Fundamentally, the fiscal preventive procedure described in the Six-Pack remains close to its old form. It consists indeed in the annual submission of “stability programmes” by the participating member states<sup>89</sup> (due now not later than 30<sup>th</sup> April). This documents, whose content shall cover a period of five years (the preceding and current years and the following three ones), serves at setting a country-specific medium-term objective (MTO) (revised every three years, instead of four previously) as well as, at defining an adjustment path towards the latter. Subject first to an external assessment, the programmes shall be then implemented. The implementation is finally monitored in order to identify the potential divergence of the budgetary positions from the MTO, or the adjustment path.

Although the outline of the procedure is maintained, Regulation No. 1175/2011, combined with the provisions dedicated to the preventive arm and mentioned in Regulation No. 1173/2011, introduces interesting new features tending to improve to effectiveness of the instrument.

First of all, the updated preventive mechanism comes now within the above-mentioned European Semester, a larger framework of economic policy

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<sup>89</sup> The non-participating member states shall submit “convergence programmes”. For a matter of simplicity, and since our interest lies on the fiscal constraint in force within the euro area, we analyse more particularly the rights and duties falling to the participating member states.

coordination. Besides, looking more precisely at the preventive arm described in Regulation No. 1175/2011, we note several changes regarding not only the content of the stability programmes, but also the assessment and monitoring procedure.

Paragraphs 2 to 4 of the third article specify the required content of the stability programme that each participating member state shall submit to the Council and the Commission. While the MTO, its adjustment path and the expected path of the general government debt ratio had to be mentioned in the initial version, the last reform requires further elements such as the expenditure and revenue figures (the planned growth path of government expenditure and, of revenue at unchanged policy), information about public implicit liabilities (liabilities related to ageing, public guarantees) and data showing the consistency of the presented programme with the EU economic guidelines and the national reform plan. Regarding the above-mentioned content, the regulation stresses finally that these country-specific programmes shall be based on the “most likely macrofiscal scenario or on a more prudent scenario”. In principle, the Commission forecasts serve as a benchmark.

Largely amended in its 2011 version, Art. 5 defines the rules and the criteria, which allow the *assessment of the stability programmes* by the Commission, the EFC and, ultimately the Council. Whereas the former requirements remain (plausible economic assumptions, coherence between the measures being proposed and the adjustment path towards the MTO, an annual improvement of the budget balance of 0.5 per cent of GDP, etc.), the Six-Pack tends to give more weight to the indebtedness criteria, almost completely neglected in practice before. More than just stipulating that the path of debt-to-GDP must be more seriously considered in the assessment, the Regulation establishes a differentiated treatment in the requirement minimum annual fiscal improvement. It imposes indeed to member states, which breach the tolerated threshold of the debt ratio, to make greater fiscal efforts. In fact, their annual improvement of budget balance should be *higher* than 0.5 per cent of GDP.

Moreover, the progress towards the budgetary MTO is now subject to an additional criterion: *the growth path of government expenditure* (excluding interest expenditure and non-discretionary changes in unemployment benefit expenditure), put into perspective with the planned evolution of the revenue side. In order to be deemed satisfactory, the national stability programmes shall present expenditure and revenue figures that respect certain conditions. Those further depend on whether the member state has already achieved its MTO or not. If it is the case, the condition is the following:

*Annual expenditure growth does not exceed a reference medium term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures.*

In contrast, for member states having not reached their MTO:

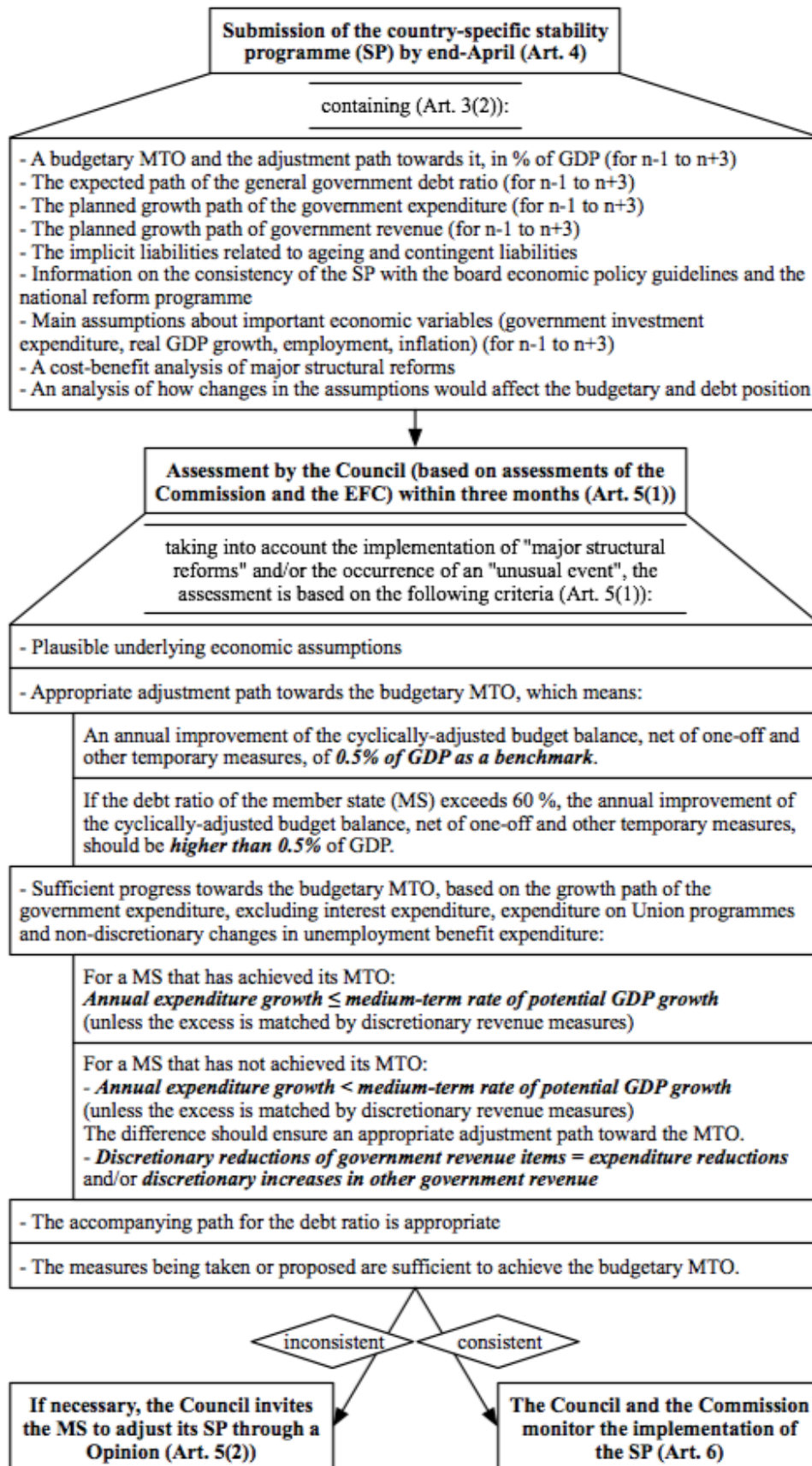
*Annual expenditure growth does not exceed a rate below a reference medium-term rate of potential GDP growth, unless the excess is matched by discretionary revenue measures. The size of the shortfall of the growth rate of government expenditure compared to a reference medium-term rate of potential GDP growth is set in such a way as to ensure an appropriate adjustment towards the medium-term budgetary objective.*

In addition, for these same member states:

*Discretionary reductions of government revenue items are matched either by expenditure reductions or by discretionary increases in other government revenue items or both.*

Considering this whole set of criteria, the Council, based on a recommendation of the Commission, may address an opinion to the member state presenting an unsatisfactory stability programme. As it was already the case before the Six-Pack, no additional arrangement is provided to the assessment procedure of the country-specific stability programmes. Figure 5-10 summarizes this first sequence of the preventive arm.

Figure 5-10: The preventive arm to this day (1/2).



After the assessment of the three-year programmes, the Council and the Commission shall monitor their implementation. They shall pay a particular attention at the identification of actual or expected “significant” deviation of the budgetary situation from the MTO and the planned adjustment path towards it (Art. 6(1)). Para. 3 specifies now the sense to be given to the term “significant” – nor the original SGP, neither the 2005 reform did it before. It defines thus that a deviation from the MTO or the appropriate adjustment path may be labelled “significant” on the basis of two criteria:

- For the member states having yet not achieved their MTO, the deviation in budget balance is considered significant if it represents at least 0.5 percent of GDP in a single year or at least 0.25 per cent of GDP on average per year in two consecutive years.
- Unless the member states concerned has “overachieved” its MTO, a divergence in the expenditure developments (net of discretionary revenue measures) that affects the budget balance of at least 0.5 per cent of GDP, or cumulatively in two consecutive years, is to be considered as significant.

As it is usually the case, a significant deviation may be ignored if resulting from an “unusual event outside the control of the member state concerned”.

Once the Commission has detected a significant deviation in the stability programme of a member state, a new procedure of correction is triggered. Whereas the old mechanism consisted only in a Council’s warning and, at worst, a eventual public recommendation addressed to the concerned member state, the Six-Pack sets a procedure, which involves clearer deadlines, more automaticity in the decision-making and, on the basis of Regulation 1173/2011, the imposition of financial sanction.

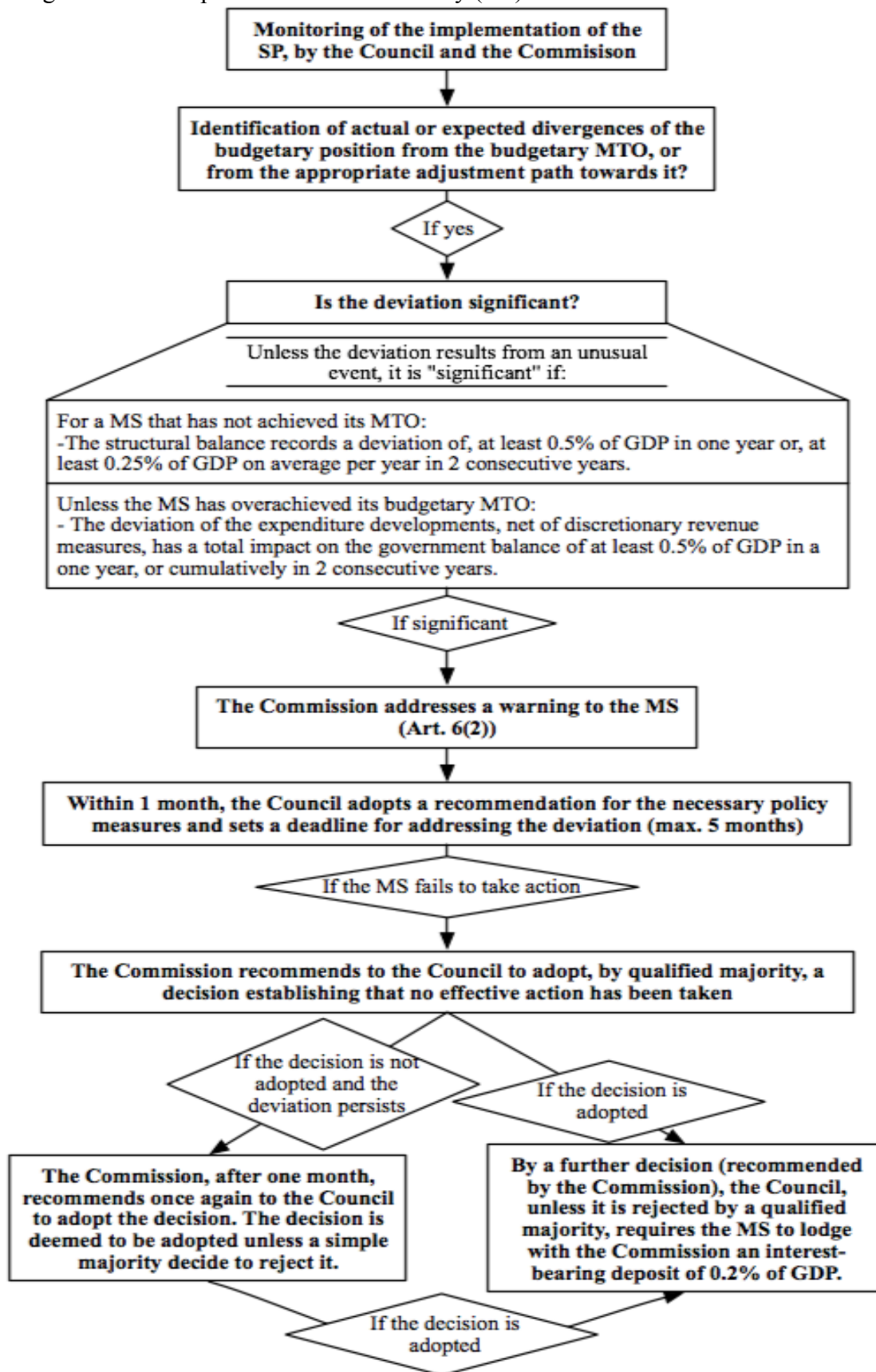
The process, which should prevent the occurrence of excessive deficit within the euro area, starts with a warning of the Commission addressed to the concerned member state. One month from the adoption of the warning, the Council formulates a Recommendation with the necessary policy measures to be implemented. This document, based of Commission’s proposal, also sets a deadline for correcting the deviation (three months, in the most serious cases,

maximum five otherwise). If recommended by the Commission, the Council may make its recommendation public. Where the Commission observes that, after the end of the deadline, the member state failed to take concrete action, it must advise the Council to adopt a decision confirming the lack of response to the initial recommendation. In a first step, the decision requires to be adopted by the Council, by a qualified majority. However, in a second step, if the Council did not adopt the decision (which is, by experience, quite likely) and the member state did not take any effective action, the Commission (one month after its last recommendation) should recommend again the council to adopt the decision. The Council, now, automatically adopts the decision, unless a simple majority rejects the Commission's recommendation (which is less likely to happen). In consequence, the adoption of the decision is made more automatic, i.e. less dependent on political considerations.

As said before, the Six-Pack endows the preventive arm of the SGP with a proper sanction mechanism, which is triggered by the above-mentioned Council's decision. Described in Art. 4 of the Regulation No. 1173/2011, the sanction, imposed to a member state that has failed to take the recommended action, consists in an *interest-bearing deposit* of, at most, 0.2 per cent of its GDP in the preceding year. Formally, the sanction has to be decided by the Council but is considered as adopted as far as it is not rejected by a qualified majority (Art. 4(2)). The deposit with the interest shall be returned to the member state when the significant deviation from the MTO or its adjustment path no longer exists (Art. 4(6)). Figure 5-11 presents the second part of the preventive, going from the monitoring to the potential imposition of sanction.



Figure 5-11: The preventive arm to this day (2/2).



### *The corrective arm*

As far as the evolution of the corrective arm is now concerned, the amendment brought by the Six-Pack, laid down in *Regulation No. 1177/2011*<sup>90</sup> as well as *Regulation No. 1173/2011*, is, generally speaking, twofold. On the one hand, similarly to the preventive arm, the corrective mechanism restores the debt criterion by giving it more weight in the procedure. On the other hand, the reform calls for an earlier implementation of the sanctions (at least for the participating member states), as well as for a smaller room for manoeuvre in the choice of the penalties to be imposed. In consequence, one must emphasise that, as it was for the preventive arm, the structure of the corrective arm of the European fiscal constraint remains mainly unchanged and, for its part, still leans on the procedure originally described in Art. 126 TFEU (see Subsection 5.1.1). Thereby, the input of the Six-Pack to the correction process of the excessive deficits consists only in an update of the enforcement rules.

Looking at the *Regulation No. 1177/2011 on speeding up and clarifying the implementation of the excessive deficit procedure* and focusing on its new features (apart from the above-mentioned elements, which are common to each legal text of the Six-Pack), we notice first the introduction of the definition of the phrase “*sufficiently diminishing and approaching the reference value at a satisfactory path*”, stipulated in Art. 126(2) TFEU and concerning the indebtedness measure. Unclearly defined until now, we remember that this characteristic of the debt-to-GDP ratio may justify a breaching in the threshold and, in consequence, allows avoiding the opening of a procedure of excessive deficit. For instance, in 1998, Belgium, whose level of public indebtedness amply overpassed the reference value, obviously put forward this argument in order to participate in the euro area. Nevertheless, nor the required adjustment path of the public debt, neither the necessary proximity to the reference value, was formally specified. From that, one may deduce that this phrase was *de facto* subject to Council’s interpretation. The insertion of Art. 2(1a) in the corrective arm contributes to clarify the situation. Henceforth, a debt-to-GDP ratio, which exceeds 60 per cent of GDP, may be

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<sup>90</sup> Regulation No. 1177/2011 on speeding up and clarifying the implementation of the excessive deficit procedure amends Regulation No. 1467/97 and, the more recent Regulation No. 1056/2005.

labelled as “sufficiently diminishing and approaching the reference value at a satisfactory path” as far as *the differential with the reference value decreases at an annual average rate (over three years) of 5 per cent*, as a benchmark. Furthermore, the condition should be considered as fulfilled if the benchmark is respected when taking into account the average rate obtained with the last fiscal year, for which data are available, and the two following budgeted years. Finally, the same article specifies that “the influence of the cycle on the pace of debt reduction” should be taken into account.

Neglecting the influence of the economic cycle, Table 5-5 illustrates the result of the implementation of this new provision. Calculating the annual average growth rate of the Belgian public debt<sup>91</sup> on the basis of the finalized fiscal figures (penultimate line), we observe that, between 2000 and 2008, the level of indebtedness should have been considered as excessive in 2001, 2002 and, more recently in 2008, in the sense of this criteria<sup>92</sup>.

Table 5-5: *Sample of the annual average growth rates of the Belgian Debt.*

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Debt/GDP	117.2	113.6	107.8	106.5	103.4	98.4	94	92	88	84	89.2
Ref. value	60	60	60	60	60	60	60	60	60	60	60
Differential	57.2	53.6	47.8	46.5	43.4	38.4	34	32	28	24	29.2
Differential annual growth rate (n-n <sub>-1</sub> )/n <sub>-1</sub>		-6.29%	-10.82%	-2.72%	-6.67%	-11.52%	-11.46%	-5.88%	-12.50%	-14.29%	21.67%
Differential average growth rate per year over 3 years			-5.81%	-4.63%	-3.17%	-6.18%	-7.81%	-5.90%	-6.27%	-9.14%	1.41%
Benchmark			-5.00%	-5.00%	-5.00%	-5.00%	-5.00%	-5.00%	-5.00%	-5.00%	-5.00%

Source: Author's elaboration from data presented in Appendix D.

Apart from the introduction of a benchmark for the level of public indebtedness, the Regulation No. 1177/2011 also updates the list of the “relevant factors”, which the Commission has to take into account when reporting the non-compliance with the public finance criteria (Art. 126(3) TFEU). Since 2011, those factors encompass figures of *the developments in the medium-term economic position* (potential growth, cyclical development, private sector net savings

<sup>91</sup> Since the exact method of calculation is not provided, the annual average growth rate has been computed according to the following formula at the initiative of the author:  $\left( \frac{\text{Differential}_n}{\text{Differential}_{n-3}} \right)^{\frac{1}{3}} - 1$

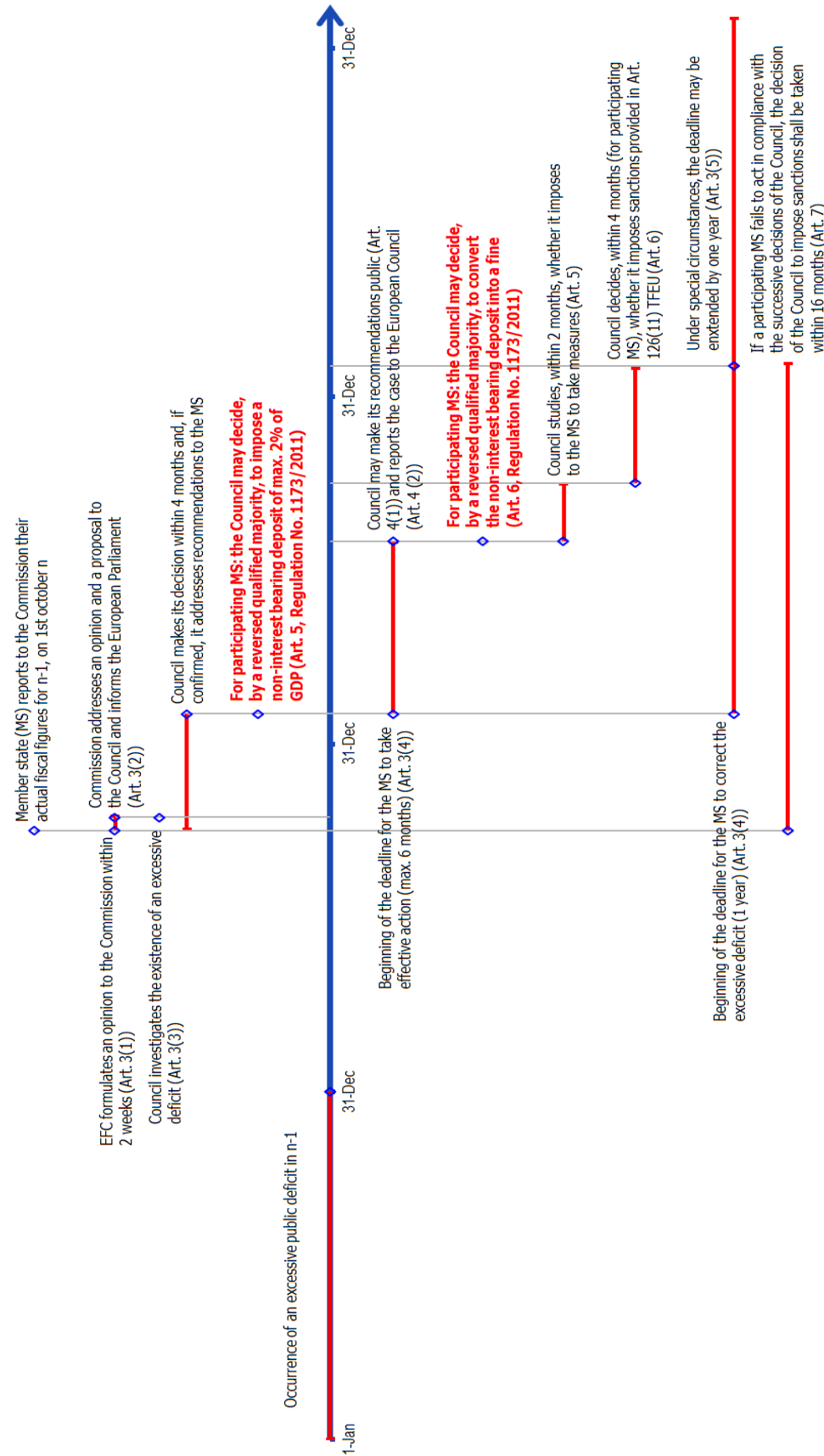
<sup>92</sup> Between 1995 and 2000, the condition was strictly fulfilled in 1998 only.

position), elements of *the developments in the medium-term budgetary positions* (the adjustment towards the medium-term budgetary objective, the level of the primary balance and developments in primary expenditure, the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances, etc.) and *the developments in the medium-term government debt position* (the debt dynamics and sustainability, stock-flow adjustment, accumulated reserves, other financial assets, guarantees, in particular those linked with the financial sector, any implicit liabilities related to ageing and private debt).

Now, the use of those factors is further subject to some conditions and their purpose is defined more precisely. Firstly, Art. 2(3) specifies that they should be deemed relevant “in so far they significantly affect the assessment of compliance with the deficit and debt criteria by the member state concerned”. Secondly, Art. 2(4) prescribes that, when assessing the compliance with the deficit criterion of the member states, whose debt ratio exceeds 60 per cent, the factors should be taken into account *only if* the deficit “remains close to the reference value and its excess over the reference value is temporary”. As far as the assessment of the debt ratio is concerned, the above-mentioned factors should be taken into account without restriction. Finally, if the Council confirms the existence of an excessive deficit, Art. 2(6) stipulates that the Commission and the Council, in their subsequent actions provided by the procedure of correction, should take into account these factors, particularly in establishing the deadlines imposed to the member state for taking effective action and for correcting the situation. In contrast, the abrogation of the measures, designed to encourage the concerned member state to mitigate its excessive deficit (Art. 126(6) to (9) and (11) TFEU), should not be decided on the basis of the relevant factors.

In addition to these new provisions regarding the principles of assessment, the procedure itself is slightly amended, not only by the several articles of Section 2 of the Regulation No. 1177/2011, but also by the Regulation No. 1173/2011, which implements sanctions earlier in the procedure. Figure 5-12 integrates these modifications and gives an overview of the complete corrective arm procedure provided to this day.

Figure 5-12: The corrective arm to this day.



Comparing Figure 5-12 with Figure 5-8, which describes the original corrective mechanism of the SGP, we note several differences. In addition to the general extension of the deadlines, which were introduced by the 2005 reform and are maintained, the Six-Pack calls indeed for a greater involvement of the European Parliament and the European Council (the heads of state of government of each member state): both Union's institutions being informed by the Council and the Commission about the advancement of the procedure. Probably more striking is however the implementation of special provisions addressed exclusively to the Eurozone member states. In a first step, a participating member state, whose non-compliance with the criteria is confirmed by the Council, may now incur a sanction following directly the latter Council's decision. Decided by the Council by a reversed qualified majority, this first sanction takes the form of non-interest-bearing deposit of a maximal amount of 0.2 per cent of the preceding year GDP. Then, if the concerned member state did not take any effective action in order to correct its excessive deficit within four months, the Council, besides making public its initial recommendations, may now harden the sanction by converting the non-interest-bearing deposit into a fine. This decision is also made by a reversed qualified majority.

Not directly related to the corrective arm, one must however note that the Six-Pack, in Art. 8 of Regulation No. 1173/2011, finally provides new sanctions against the manipulation of statistics. In such cases, the Council, based on a recommendation of the Commission, may impose a fine of, at most, 0.2 per cent of GDP.

#### *5.4.3 Provisions against macroeconomic imbalances*

Contrary to the above-mentioned Regulations amending the SGP, the two legal bases concerning the detection and the correction of excessive macroeconomic imbalances constitute an additional instrument, which operates in parallel to the European fiscal constraint. Since this so-called *macroeconomic imbalance procedure (MIP)* is not directly related to the Maastricht fiscal criteria and their implementation, we wish to simply present the main principles and components of this “overlapping” new mechanism, without entering into its details.

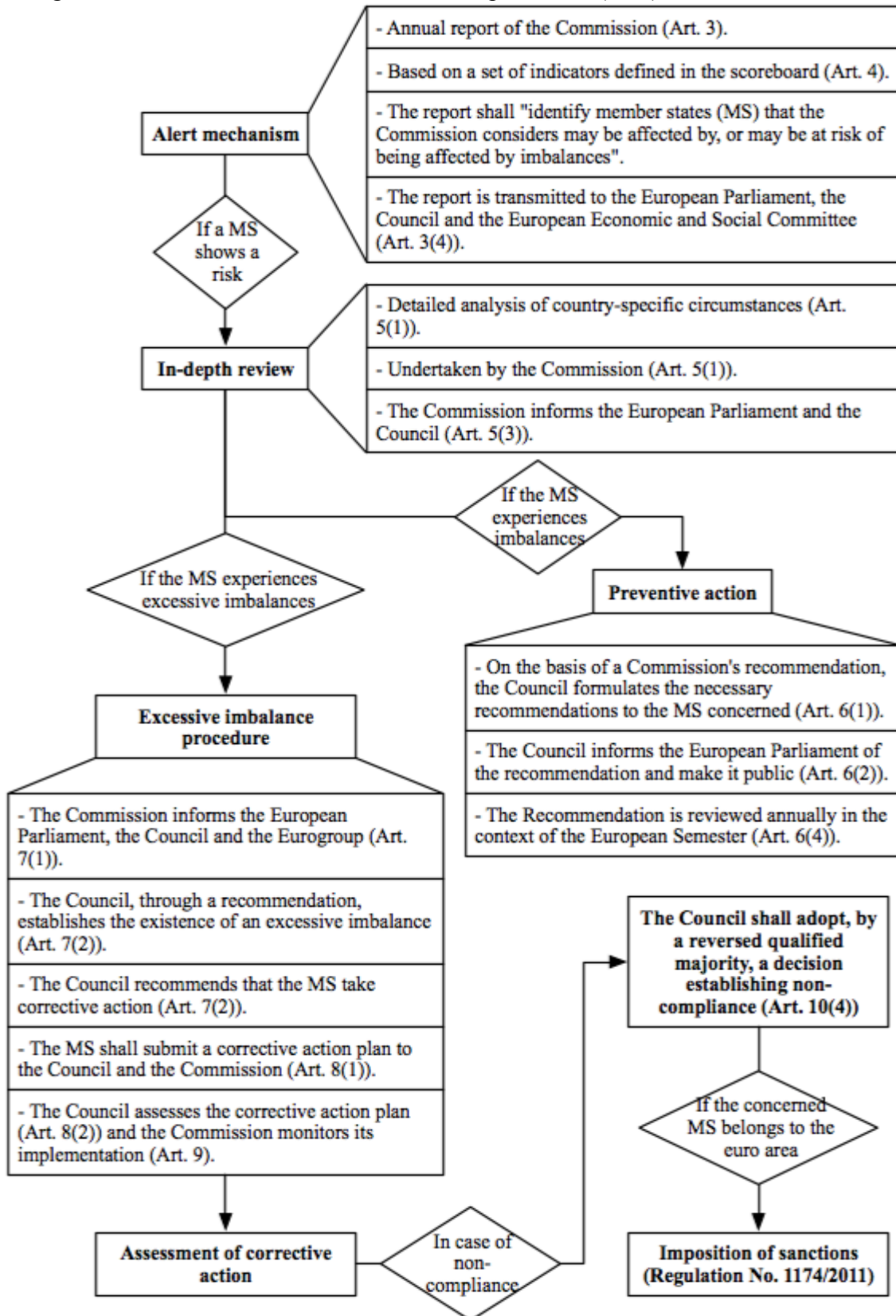
To begin with, a good understanding of the MIP requires investigating the *Regulation No. 1176/2011 on the prevention and correction of macroeconomic imbalances*, which applies to all EU member states. Figure 5-13 sketches the institutional design of this regulation, which is articulated into four steps, which are potentially triggered one after the other according to the result of the preceding one.

The surveillance mechanism starts thus with the Commission's annual "*Alert Mechanism Report*" (Art. 3). On the basis of a *scoreboard*, which consists in a set of macroeconomic and macrofinancial indicators chosen by the Commission<sup>93</sup> (Art. 4), this report serves as a filter allowing the identification of member states recording an alarming or suspicious macroeconomic development, and requiring, therefore, a deeper analysis. These so-called "*in-depth reviews*" provide thus a detailed analysis of the country-specific circumstances, in which existing or potential imbalances have been previously detected. By doing so, the Commission may evaluate the gravity of the issue. Where it estimates that the macroeconomic imbalance does not "jeopardise or risks jeopardising the proper functioning of the economic and monetary union" (Art. 2), the Commission only recommends the Council to "address the necessary recommendations to the member state concerned" (Art. 6(1)). The Council reviews its recommendation annually. This "branch" of the procedure is referred to as the "*preventive action*". In contrast, if the imbalance is considered as *excessive*, i.e. it may endanger the EMU as a whole, the "*Excessive Imbalance Procedure*" – the corrective arm of the MIP – is triggered (Art. 7). In the latter case, the member state concerned has to define a corrective action plan and submit it to the Council and the Commission (Art. 8(1)). After being assessed and deemed sufficient by the Council, the Commission monitors the implementation of the plan (Art. 9). Later, based on Commission's report, the Council assesses whether the member state has stuck to the plan.

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<sup>93</sup> In the 2012 Alert Mechanism Report (European Commission, 2012b: 3), the Commission defined ten indicators: the current account balance, the net international investment position, the real effective exchange rate, the export market shares, the nominal unit labour cost, the deflated house prices, the private sector credit flow, the private sector debt, the general government debt, the unemployment rate. Additionally, for each of the latter, indicative thresholds are specified.

Figure 5-13: The macroeconomic imbalance procedure (MIP).





For the eurozone countries, the enforcement of the mechanism is reinforced by the provision of potential sanctions, which are defined in another legal text: Regulation No. 1174/2011 on enforcement measures to correct macroeconomic imbalances in the euro area. Thereby, an interest-bearing deposit of at most 0.1 per cent of GDP (voted by reversed qualified majority) is imposed by the Council, when the latter establishes that the corrective action plan has not been adequately followed (Art. 3(1)). Moreover, annual fines of the same maximal amount may be addressed to a member state if it has either submitted two successive insufficient corrective action plans (Art. 3(2a)), or it remains in situation of non-compliance regarding the implementation of the plan. In the latter case, the interest-bearing deposit is converted into a fine (Art. 3(2b)).

#### *5.4.4 Towards the standardisation of the national fiscal framework*

The Six-Pack encompasses one more legal document, which needs to be presented: *Directive 2011/85/EU on requirements for budgetary frameworks of the member states*. Contrasting with the others, this EU document is of a different nature, which implies slightly different modalities of implementation. In fact, as defined in Art. 288 TFEU, a Directive “shall be binding, as to the result to be achieved, upon each member states to which it is addressed, but shall leave national authorities the choice of form and methods”. Concretely, this implies that the member states have a certain period of time at their disposal for bringing into force the provisions necessary to comply with the Directive in their respective national legislation. So, in the present case, Directive 2011/85/EU entered into force in December 2011 (like the other legislative acts of the Six-Pack), but should be translated into national laws by 31<sup>st</sup> December 2013 (Art. 15(1)). Having in mind this practical consideration, let us have a look at the content of this Directive, which constitutes an important development towards a greater standardisation in the national budgetary frameworks (Catania, 2011: 4).

With the implementation of this Directive, the European fiscal discipline instrument defines, for the first time, “detailed rules concerning the characteristics of the budgetary frameworks of the member states” (Art. 1). For the purposes of

the Directive, the term “budgetary framework” is taken in its large sense and covers particularly (Art. 2):

- the systems of budgetary accounting and statistical reporting,
- the rules and procedures governing the preparation of forecasts for budgetary planning,
- the country-specific numerical fiscal rules (expressed in terms of a summary indication of budgetary performance),
- the budgetary procedures comprising procedural rules to underpin the budget process at all stages,
- the medium-term budgetary frameworks,
- the arrangement for independent monitoring and analysis,
- the mechanisms and rules that regulate fiscal relationships between public authorities across sub-sectors of general government.

Before even investigating the exact degree of standardisation desired by the Directive, one must note that the above-mentioned list of fields concerned by this national methodological “reconciliation”, itself, translates an unprecedented will for a greater fiscal unification. Quoting Catania (2011: 7), “the member states are not willing to go for a full fiscal union, but we are now closer than ever to this stage”.

In order to present more precisely, and in a comprehensible way, the content of this Directive, we divide the description into the several chapters forming this legal act. Accordingly, we shortly expose the provisions of the Directive concerning (1) the accounting and statistics, (2) the forecasts, (3) the numerical fiscal rules and, (4) the medium-term budgetary frameworks. Covering all those fields, Art. 12 to 14 specify that all new provisions should be consistent across all sub-sectors of public sector (as defined by the ESA 95) and implemented through “appropriate mechanisms of coordination”.

Firstly, Art. 3 imposes the member states to implement, for all sub-sectors of general government, national systems of public accounting consistent with the standards described by the ESA 95. These systems must furthermore be subject to internal control, as well as independent audit (Art. 3(1)). The second paragraph

of the same article also impresses the member states to publish not only cash-based fiscal data (monthly for the central government, state governments, social security and quarterly for the local governments), but also a so-called reconciliation table explaining the transition between cash-based data and data based on the ESA 95 (Art. 3(2)).

Secondly, Art. 4 of the Directive calls for more transparency and realism in the member states' forecasts. The article starts by reiterating the need for member states to ensure that national fiscal planning relies on "realistic macroeconomic and budgetary forecasts using the most up-to-date information". Moreover, it states that the budgetary planning should be built on the most likely, or more prudent, macrofiscal scenario (Art. 4(1)). On the transparency side, Art. 4(5) stipulates that the member states should determine which national institution is in charge of producing such forecasts and make public "the official macroeconomic and budgetary forecasts prepared for fiscal planning, including the methodologies, assumptions and relevant parameters underpinning those forecasts". Besides, these forecasts are regularly subject to *ex post* assessments, so that, in case of persistent divergences with the reality, the member state concerned may adapt its methods (Art. 4(6)). The directive finally calls for more regular publications of the member states' debt and deficit levels. It makes thus the Commission – via Eurostat – responsible for publishing these national figures every three months (Art. 4(7)).

Thirdly, the Directive builds a first "bridge" between the European fiscal constraint, set at the Union's level, and the national instruments of fiscal discipline (see the link between the upper and bottom part of Figure 5-2). From this viewpoint, Art. 5 constitutes indeed a interesting advancement towards a closer connection between the supranational constraint and its transposition into national legislations. Concretely, the Directive demands that each member state (except the United Kingdom (Art. 8)) puts in place "numerical fiscal rules" promoting compliance with the budgetary provision of the TFEU, i.e. the debt and deficit reference values, as well as the MTO. Without specifying in details the exact form to be taken by these rules, the Directive sets however some minimal requirements. Thereby, the national numerical fiscal rules should contain: "the

target definition and scope of the rules, the effective and timely monitoring of compliance with the rules, based on reliable and independent analysis and carried out by independent bodies and the consequences in the event of non-compliance” (Art. 6). In addition, if a given fiscal rule defines “exit doors”, such special circumstances should be limited and consistent with the ones specified in the European fiscal constraint (Art. 6(2)). Finally, the national fiscal constraints should be taken into account in the annual budget legislation (Art. 7).

Lastly, the Directive of the Six-Pack specifies that the Union’s member states establish a national medium-term budgetary framework, providing a fiscal horizon of, at least three years (Art. 9(1)). Such framework should be designed in a way that facilitates the computation of the following items: comprehensive and transparent multiannual budgetary objectives, projections of each major expenditure and revenue item of the general government, a description of medium-term policies envisaged with an impact on general government finances, and an assessment of the long-term impact of the policies envisaged on the public finances sustainability (Art. 9(2)).

### **5.5 The Treaty on stability, coordination and governance (TSCG)**

The forth “institutional layer” of the European fiscal constraint slightly differs from the others in two ways. Firstly, contrary to the revised SGP (Section 5.3) and, partly the Six-Pack (Section 5.4), the TSCG is formally not a reform of the initial SGP (Section 5.2) but rather “overlaps” the existing European fiscal discipline instrument. It runs thus in parallel with the existing European fiscal legislations and completes, under several aspects, the Maastricht criteria and the more recent Six-Pack. Put differently, it may be seen as a further step forward in the reform process initiated by the EU in reaction to the crisis. The second difference relies on the legal nature of the document. Contrasting with the legal bases studied until now, the TSCG is formally not a EU law, but rather an *intergovernmental agreement* (which does not mean that its provisions are not binding). However, Art. 16 of the latter specifies that the substance of the text

should be incorporated into the legal framework of the EU within five years following its entrance into force<sup>94</sup>.

Commonly referred to as the “Fiscal Compact”, this Treaty has been imagined in early 2012 in response to a double request from Germany and the ECB. On the one hand, the German Chancellor defended conditioned financial helps to struggling countries, depending on the improvement of their respective fiscal discipline. On the other hand, the President of the ECB suggested at the end-2011 that the implementation of a new “fiscal pact” would encourage his institution to increase its support to the euro area (Guélaud *et al.*, 2012: 1). It is in this context that the UE member states (except from the United Kingdom and the Czech Republic) agreed on the TSCG in March 2012. Entered into force on 1<sup>st</sup> January 2013<sup>95</sup>, the Treaty applies in full to the *contracting parties whose currency is the euro* (as far as the text has been ratified at the national level) (Art. 1(2) and Art. 14(3)). For other contracting parties, the Treaty will be binding as soon as they adopt the common currency, unless they declare their “intention to be bound at an earlier date” (Art. 14 (5)).

Schematically, the provisions described in the TSCG covers three distinctive fields. It contains indeed *fiscal provisions* (Art. 3 to 8), *policy coordination principles* (Art. 8 to 9) and *governance rules* (Art 12 and 13). Although some of those provisions are concepts coming directly from the Six-Pack, the Treaty brings some innovations that are worth noting. As far as the policy coordination and governance rules are concerned, one must nevertheless acknowledge that the TSCG introduces only a few new features, whose ins and outs are minimally described. Regarding the improvement of the policy coordination, the Treaty just states that “all major economic policy reforms that [the contracting parties] plan to undertake will be discussed *ex ante* and, where appropriate, coordinated among themselves” (Art. 11). The details about the transposition of this objective into practice are however missing. Concerning the governance issue, the contracting

<sup>94</sup> For instance, some of these principles have already been integrated in the Two-Pack regulation.

<sup>95</sup> The entrance into force of the Treaty was conditioned. Art. 14(2) states indeed that it shall be implemented on 1<sup>st</sup> January 2013, “provided that twelve contracting parties whose currency in the euro have deposited their instrument of ratification”. The ratification of Finland on 21<sup>st</sup> December 2012 marked thus the fulfilment of the latter condition and allowed the entrance into force on schedule.

parties agreed only on the organisation, at least twice a year, of “Euro Summit” meetings, which would gather the Heads of States of the Eurozone participants (Art. 12). This new platform would allow the members of the monetary union to discuss specific questions related to the Eurozone.

Fortunately, looking now at the fiscal part of the TSCG, the text becomes more consistent in terms of content, although it reaffirms some principles already present in the Six-Pack. Moreover, these fiscal provisions, when published, have known wide media coverage, since they have been perceived (and described by their authors) as an introduction of a “golden rule” to be applied nationally by the member states. But how does the Fiscal Compact define this concept and what are the other fiscal components of this intergovernmental Treaty?

Art. 3(1) of the Fiscal Compact prescribes that “the budgetary position of the general government of a contracting party shall be balance or in surplus” with the indirect specification that the term “budgetary position” refers to the “annual structural balance” or, more precisely, the “annual cyclically-adjusted balance net of one-off and temporary measures” (Art. 3(3)). In addition, the phrase “balance or in surplus” should be tempered since the Treaty says that it would admit a structural deficit 0.5 per cent of GDP, at most. Likewise, under the condition that the debt-to-GDP ratio of the concerned member state is “significantly below 60 per cent”<sup>96</sup>, the structural deficit may reach 1 per cent of GDP. Finally, we find the traditional escape clause. Accordingly, a member state may deviate from the above-mentioned fiscal target, as far as the deviation remains temporary or due to exceptional circumstances<sup>97</sup>. At that point, except from the differentiation made between heavily and low indebted countries and, a slightly stricter deficit limit for the member states whose currency is the euro, these provisions correspond quite closely to the ones prescribed in the Six-Pack. The innovation lies however on enforcement of these principles. Art. 3(2) stipulates indeed that these rules “take effect in the national law of the contracting parties”, and preferably in their respective constitutions. While the Directive 2011/85/EU on requirements for budgetary frameworks of the member states (see Subsection 5.4.3) called for the

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<sup>96</sup> The adjective “significant” is not specified.

<sup>97</sup> The escape clause is defined in accordance with the related provisions set in the Six-Pack.

implementation of national numerical fiscal rules in the EU member states, the TSCG specifies, for the euro area participants, the sense to be given to the constraint. These national fiscal rules should also provide a “correction mechanism [that] shall be triggered automatically”. The contracting parties have until 1<sup>st</sup> January 2014 to transpose this European “golden rule” into their national legislation (the provisions of the above-mentioned directive should be implemented by 31<sup>st</sup> December 2013). If a contracting party fails in properly implement the fiscal rules in its national legislation, it risks “a lump sum or a penalty payment” of 0.1 per cent GDP. The sanction is here imposed by *the Court of Justice* (Art. 8) and not the Council, as it is usually the case.

Looking back at the definition of the “golden rule” that we formalize in Subsection 4.1.2, we observe that the European concept is quite different. To mention only one of these dissimilarities, the existence of the escape clause offers an opportunity for the Eurozone member states to “dilute” the essence of the concept. For this reason, one may consider that the term “golden rule” is actually misused with regard to its strict economic meaning.

The Fiscal Compact is not limited to the introduction of the European “golden rule”. Besides reaffirming the minimal required adjustment path of the public debt (Art. 4) that is set in the Six-Pack (see Subsection 5.4.1), the Treaty introduces three new elements. Firstly, Art. 5 specifies that, when a contracting party faces an excessive deficit procedure, in addition to the opening of a corrective procedure (Figure 5-12), it must put in place a “*budgetary and economic partnership programme*”. This document consists in the formulation of a “detailed description of the structural reforms” that the concerned country plans to undertake. The assessment and monitoring of such programme should be inserted into the surveillance procedure described in the Six-Pack. Secondly, from now on, the public debt issuance plans of the euro area member states should be reported *ex ante* to the Council and the Commission in order to improve the coordination among participating countries (Art. 6). Finally, after the introduction in the Six-Pack of the system of reversed qualified majority to some of the Council’s decision-making process, the Treaty makes a further step towards more automaticity and better enforcement of the Pact. Art. 7 indeed provides that the

contracting parties commit to supporting the proposals and recommendations of the Commission concerning the existence of excessive deficit, unless a qualified majority of is against the decision. Concretely, this provision means the implementation of the reverse qualified majority voting to the whole corrective arm of the Pact, as far as it concerns euro area member states.

## **5.6 The “Two-Pack”**

Recently published in the Official Journal of the European Union (27<sup>th</sup> May 2013) and entered into force shortly after (31<sup>st</sup> May 2013), the so-called “Two-Pack” regulation constitutes, today, the last institutional piece of the European fiscal constraint. As its name indicates, the Two-Pack encompasses two Regulations: *Regulation No. 472/2013 on the strengthening of economic and budgetary surveillance of member states in the euro area experiencing or threatened with serious difficulties with respect to their financial stability* and *Regulation No. 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the member states in the euro area*. Applicable to the Eurozone member states only, these two legal acts aim at strengthening the several surveillance mechanisms in the euro area in order to avoid potential contagion effects within the monetary union. While Regulation No. 473/2013 applies to all euro area participants and sets common budgetary provisions and closer monitoring in the excessive deficit procedure, the Regulation No. 472/2013 is particularly designed for enhanced surveillance intended for the ones in financial distress only. Besides, both regulations attempt to simplify the coordination between the different mechanisms that we have presented in the previous sections.

In order to understand more precisely what brings this last instrument, we articulate our description of these legal bases by simply analysing one after the other.

### *5.6.1 Regulation No. 472/2013*

Applied to the EU member states whose currency is the euro, the provisions described in Regulation No. 472/2013 introduces two main instruments designed for countries in financial difficulties. On the one hand, Art. 2 to 4 of the text



introduce a *gradual surveillance system*, which aims at differentiating the fiscal monitoring imposed to the member states according to their financial situation. On the other hand, Art. 5 to 14 describe a set of additional conditions intended for the countries in receipt or requesting external financial assistance. Among these requirements, we find, for instance, the compulsory submission of macroeconomic adjustment programmes.

#### *The enhanced surveillance*

In order to reinforce the preventive arm of the European fiscal constraint, the Regulation No. 472/2013 puts in place an extra surveillance mechanism referred to as the “*enhanced surveillance*”. Especially designed for the euro member states who present special circumstances<sup>98</sup>, this preventive tool implies that the concerned countries are subject, on the one hand, to regular closer monitoring and, on the other hand, to additional obligations.

For a member state, two situations may lead to an enhanced surveillance: (1) *experiencing or being threatened with serious financial difficulties* (Art. 2(1)) and, (2) *being in receipt of precautionary financial assistance* (Art. 2(3)). The Regulation further specifies this classification. Thereby, the threat “with serious difficulties with respect to financial stability” of a given member state should be estimated by the Commission on the basis of: its alert mechanism and in-depth review (if available) (see Subsection 5.4.3), its borrowing conditions, the repayment profile of its debt obligations, the robustness of its budgetary framework, the long-term sustainability of its public finances, the importance of its debt burden and the risk of contagion from severe tensions in its financial sector on its budgetary situation or on the financial sector of other member states. If the Commission finds out the existence of a threat, it should repeat the assessment every six months and decide whether to prolong the enhanced surveillance or not. Similarly the “receipt of financial assistance” is limited to assistance programmes received “from one or several other member states or third countries, the European Financial Stabilisation Mechanism (EFSM), the European Stability Mechanism (ESM), the European Financial Stability Facility (EFSF), or

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<sup>98</sup> The others remain subject to the “standard” surveillance mechanism laid down in Regulation No. 1175/2011.

another relevant international financial institution such as the International Monetary Fund (IMF)”. The financial assistance received in the form of a credit line, unconditioned by the adoption of specific policy measures, is excluded by the definition and, consequently, does not lead to an enhanced surveillance (Art. 2(4)).

The third article of the regulation describes then the ins and outs this enhanced surveillance. First of all, when subject to enhanced surveillance, the concerned member state shall undertake measures “aimed at addressing the sources or potential sources of difficulties” (Art. 3(1)). The latter should be discussed with the Commission<sup>99</sup> and, afterwards, transmitted to the European Parliament, the EFC, the Eurogroup Working Group and the national parliament. As far as the monitoring is concerned, the enhanced surveillance follows the procedure laid down in the second regulation of the Two-Pack under the Art. 10(2), (3) and (6). It is thus provided that the concerned member state carry out assessment of in-year budgetary execution for the general government and its subsectors, covering in particular the contingent liabilities with potential large impacts on public budgets. Moreover, the Commission and the EFC shall be regularly informed of the in-year budgetary execution, the nature, as well as the budgetary impacts, of the measures taken or envisaged. Finally, the member state is constrained, on request from the Commission, to further carry out independent audit of the public accounts and provide additional information.

Besides the general monitoring procedure, the Commission may, in the framework of the enhanced surveillance, impose further obligations to the concerned member state (Art. 3(3) and Art. 3(4)). The latter may be asked (1) to communicate to the ECB (and eventually to the relevant ESAs) disaggregate information on developments in its financial system, (2) to undertake stress test exercises or sensitivity analyses of its financial sector, (3) to submit regular assessments of its ability to supervise its financial sector, (4) to transfer to the Commission any information required for the monitoring of the macroeconomic

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<sup>99</sup> In this context, the Commission should act in liaison with the ECB, the relevant European Supervisory Authorities (ESAs), the European Systemic Risk Board (ESRB) and, where appropriate, the IMF.

imbalances. In view of these elements and of its regular review missions (Art. 3(5)), the Commission informs the relevant committee of the European Parliament and the EFC of the progress made by the member state, on a quarterly basis. In case of insufficient result, the Commission may recommend, through a Council's Recommendation (acting by a qualified majority), the adoption of precautionary corrective measures. Where appropriate, the member state may be constrained to prepare a macroeconomic adjustment programme (see the following paragraph).

#### *Requirements of the financial assistance*

The second important facet of this Regulation consists in providing special requirements to the member state requesting or benefiting from external financial assistance (as defined previously).

To begin with, in the requesting phase, the concerned member state shall now inform the President of the Eurogroup Working Group, the person in charge of the economic and financial affairs within the Commission, and the President of the ECB (Art. 5). That way, the Eurogroup Working Group may discuss the existing possibilities to respond positively to the request, using one or the other Union or euro area financial instruments. In parallel, the Commission should carry out an assessment of the sustainability of the member state's public debt (taking into account the impact of potential macroeconomic and financial shocks), as well as an evaluation of the financing needs of the latter (Art. 6).

For its part, the concerned member state, collaborating with the Commission<sup>100</sup> and taking into account the view of its social partners (Art. 8), prepares a draft "*macroeconomic adjustment programme*"<sup>101</sup>. The document should be drawn up with the purpose of "rapidly re-establishing a sound and sustainable economic and financial situation and restoring the member state's capacity to finance itself fully on the financial markets" (Art. 7(1)). A particular attention should be paid to the reinforcement of "the efficiency and effectiveness of revenue collection capacity and the fight against tax fraud and evasion" (Art. 9). The Council (acting by a

<sup>100</sup> Here again, the Commission should act in liaison with the ECB, the relevant ESAs, the ESRB and, where appropriate, the IMF.

<sup>101</sup> Such programme may substitute, if it already exists, the Economic Partnership Programme. This kind of documents is prepared by the member states when they are in situation of excessive deficit (see Subsection 5.6.2.).

qualified majority) should then approve the programme (Art. 7(2)). When subject to such programme, the member state should undertake an audit of its public finances in order to reveal, firstly, the reasons of the excessive public indebtedness and, secondly, the potential accounting irregularities (Art. 7(9)).

In charge of the monitoring, the Commission informs the EFC of the member states' progress, every three months (Art. 7(4)). According to the updated macroeconomic forecasts, it may also address a recommendation to the Council, calling for an adjustment of the programme (Art. 7(5)).

Where the monitoring highlights significant deviations for the agreed programme, the Council (by a qualified majority) may confirm the non-compliance and impose the member state to take measures. Those ones should allow “stabilising the markets and preserving the good functioning of the financial sector” (Art. 7(7)). If appropriate, the Commission may provide administrative and technical assistance to the country in distress (Art. 7(8)).

As long as a minimum of 75 per cent of the financial help received from the above-mentioned lenders has not been repaid, the member state is placed under a “*post-programme surveillance*” (Art. 14(1)). Looking alike an enhanced surveillance under many aspects, this procedure involves especially regular review missions, which may trigger (in case of unsatisfactory results) the adoption of corrective measures. The Council, acting by reversed qualified majority, would decide those (Art. 14(4)).

Finally, one must note the desire expressed by the European legislator to secure the consistency of the macroeconomic adjustment programme with the other obligations already imposed on the member states. Thereby, Art. 10 sets that, if subject to macroeconomic adjustment programmes, a member state is exempt from the submission of stability programme and eventually, from the regular reports required under the corrective arm (Art. 126(9) TFEU). Similarly, the macroeconomic imbalance procedure, the monitoring implied in the European Semester, and the risk of being placed under an economic partnership programme, shall be put in abeyance (Art. 10 to 13).

### 5.6.2 Regulation No. 473/2013

Also applied exclusively to the member states whose currency is the euro, the second regulation of the Two-Pack enriches both the fiscal preventive and corrective arm, as amended by the Six-Pack. While control over the formulation of the national budgets is integrated into the former, the latter is completed by a system of gradual monitoring fostering the timely and durable correction of the excessive deficits.

#### *Common budgetary provisions*

Whereas the first milestones of a common budgetary and economic coordination calendar were initially introduced by the SGP with the submission of the national stability programmes in spring, the mechanism has been further developed over the years and the successive reforms. More recently, the European Semester enhanced the policy-making coordination within the EU by setting an annual governance cycle. The implementation of the *common budgetary provisions* described in the Two-Pack comes within this framework and constitutes an additional step toward a closer monitoring of the national budgetary plans.

Firstly, Art. 4 of Regulation No. 473/2012 determines the *common budgetary timeline*, which rhythms now the European Semester and, more particularly, the formulation of the national budgets. In accordance with the provisions laid down in the Six-Pack, Para. 1 of this article begins with reaffirmation that the country-specific stability programmes, as well as the national reform programme, shall be submitted annually by the member states “preferably by 15<sup>th</sup> April but no later than 30<sup>th</sup> April”. Art. 4(2) and (3) specifies respectively the two other major deadlines imposed on the member states: their “draft budget for the forthcoming year of the central government and the main parameters of the draft budgets for all the other subsectors” should be published no later than 15<sup>th</sup> October; their budget for the central government should be adopted and made public no later than 31<sup>st</sup> December.

Secondly, the Regulation makes clear that the stability programme, the national reform programme and the draft budget shall be *based on independent macroeconomic forecasts* (Art. 4(4)), i.e. produced by an independent body.

Moreover, such “agencies” should also be responsible for the monitoring of the compliance with the national fiscal rules introduced by the Directive of the Six-Pack (see Subsection 5.4.4).

Thirdly, the Two-Pack provides now that the draft national budgetary plans, submitted in October, shall be assessed and approved by the competent EU institution before their adoption in December. The required content of these documents is therefore precisely defined and should include (Art. 6(3)):

- the targeted budget balance for the general government (with the measure for each subsector) as a percentage of GDP;
- several measures of expenditure and revenue of the general government as percentage of GDP (projections at unchanged policies, targeted figures given the conditions of expenditure growth path, according to a functional classification, broken down by subsector);
- the assumptions and the methodology underlying the macroeconomic forecasts;
- elements showing the consistency of the draft budgetary plan with the Union’s strategy for growth and employment.

The draft budget should be then submitted to the Commission – the controlling institution – and to the Eurogroup by the due date (Art. 6(1)). Besides controlling the compliance of the budgetary plan in terms of content, the Commission should also investigated the consistence of the document with the recommendations issued in the context of the Six-Pack. Based on this assessment, the Commission should adopt an opinion on the document no later than 30<sup>th</sup> November (Art. 7(1)). Where the Commission identifies, in the budget draft, serious non-compliance, it shall adopt its opinion earlier and no later than two weeks after the submission. In this case, the concerned member state should revised its budgetary document within three weeks. The Commission should discuss and adopt a new opinion on the revised text within three weeks following the submission of the second draft. Ultimately, the Commission’s opinion shall be made public (Art. 7(3)).

Finally, on the basis of all national budgetary plans, the Commission provides an overall analysis of the euro area budgetary situation. At that occasion, the

Commission shall point out “the risks to public finance sustainability in the event of adverse economic and financial or budgetary developments” (Art. 7(4)). This overall study shall further serve as the discussion paper, on which the Commission should base its annual general guidance to member states.

*Closer monitoring in the EDP*

As noted previously, the Regulation No. 473/2013 exposes also additional provisions regarding the fiscal corrective procedure. Its major feature consists in the requirement, for member states in situation of excessive deficit, of presenting an *economic partnership programme*<sup>102</sup>. This document should precisely describe “the policy measures and structural reforms that are needed to ensure effective and lasting correction of the excessive deficit” (Art. 9(1)). It should particularly help the concerned member state to determine its priorities, which would allow reinforcing its competitiveness, as well as its long-term sustainable growth. Its submission to the Commission and the Council comes within the schedule of the corrective arm and should be simultaneous with the report on the effective action taken in response to the first Council’s recommendation (Art. 3(4a) Regulation No. 1177/2011). The monitoring of the programme is under the responsibility of the Council and the Commission (Art. 9(6)). In a purpose in limiting the multiplication of procedure, Art. 9(5) allows that the economic partnership programme could be replaced by a corrective action plan<sup>103</sup> – if amended accordingly.

Besides the formulation of an economic partnership programme, a member state, in situation of excessive deficit, is also forced to comply with additional conditions. These conditions consist mainly in supplementary reporting requirements on a regular basis until the abrogation of the EDP (Art. 10). The member states shall, for instance, report to the Commission and the EFC assessments of the in-year budgetary execution (every six months) for its general government and its subsectors. They particularly highlight the financial risks associated with its contingent liabilities, as well as the impact of those on their

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<sup>102</sup> The TSCG mentioned already such programme (see Section 5.5). It is now formally incorporated into the EU law.

<sup>103</sup> Document to be submitted under the corrective mechanism of the MIP. See Subsection 5.4.3.

excessive deficit. On a request from the Commission, the member state may be asked to undertake an independent audit of its public accounts and provide further information helping in the monitoring of the correction of the excessive deficit (Art. 10(6)).

The above-mentioned regular reports submitted by the concerned member state serve then as the basis for the monitoring of the Commission. This EU institution shall particularly assess whether the member states follows the correction calendar or, on the contrary, presents a risk of breaching the deadlines. In the latter case, the Commission addresses to the member state a recommendation either encouraging it to fully implement the measures already proposed, or mentioning the adopting of new ones (Art. 10(2)). This recommendation should also be followed by a report of the concerned country (Art. 10(3)).



## 6 Institutional assessment and review of Maastricht criteria

The last chapter of Part II concludes our study and attempts finally to provide some responses to our central question: to what extent is the European instrument for fiscal discipline an adequate fiscal constraint? In order to do so, we confront our institutional reading of the European legislation (Chapter 5) with the criteria, based on the economic meaning of fiscal discipline and developed in Chapter 4.

As a reminder, Chapter 5 provides a chronological description of the construction of the European fiscal discipline instrument. Rather than assessing each successive development step of the constraint (the Maastricht criteria, the SGP, the revised SGP, etc.) and evaluate their individual contribution to the whole arrangement, our analysis concentrates on the fiscal rules in force to date (June 2013). Whereas many authors published qualitative assessments of the European fiscal rules at different periods, and thus, covering the several stages of construction<sup>104</sup>, the present study is, to our knowledge, the first one to encompass a sequence going until 2013.

Besides, we also recall that Chapter 4 identified the different features and principles that a fiscal rule should ideally contain and respect. Based on these relevant characteristics, we exposed two sets of criteria. Proposed initially by Kopits and Symansky (1998: 18-19), the first one consists in a set of general properties, which should ideally be respected (Subsection 4.2.1). The second set of criteria is articulated in a sequence of key questions pointing out the main aspects of a fiscal constraint and ultimately allowing ranking the instrument according to its degree of strictness (Subsection 4.2.2). Designed by Dafflon (1996: 240-243) and replicated several times afterwards, always in a comparative purpose – for instance, for the comparison of the degree of fiscal discipline in force among the Swiss cantons (Novaresi, 2001) – the method is here somehow diverted from its original aim. Instead of using it as a benchmark, it serves us to bring out some elements of interest and concentrate our analysis on them.

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<sup>104</sup> For studies dealing with the initial Maastricht criteria, see for instance Buiters *et al.* (1993) or Holzmann *et al.* (1996); with the SGP, Artus *et al.* (2004) or Fatás *et al.* (2003); with its revised version, Diebalek *et al.* (2006); and with the Six-Pack, Schuknecht *et al.* (2011).

Taking into account both preceding chapters and following the logical flow of this second part, we articulate the present chapter into two sections. While Section 6.1 analyses the European fiscal constraint in the light of the first set of criteria, Section 6.2 confronts the latter with some of Dafflon's key issues. Together, this chapter not only provides a global assessment of the institutional design of the EU fiscal rule, but also tries to underscore some shortages implied in the legislative arrangement in force nowadays.

### 6.1 The EU fiscal constraint in light of the optimal criteria

As pointed out in Subsection 4.2.1, the criteria allowing the assessment of any fiscal constraint should cover two properties: the *efficiency* of the concerned rule and its *enforceability*. In order to investigate deeper each of these aspects, we have exposed a set of criteria, related more specifically to the one or the other. Table 6-1 recaps those criteria and sums up their respective scope.

Table 6-1: *The criteria of an optimal fiscal rule.*

	Criteria	Meaning
Efficiency	<i>Consistency with the goals</i>	Is the rule appropriate in order to achieve the stated goals?
	<i>Credibility</i>	Are the sanctions clear and effective?
	<i>Adaptability - Flexibility</i>	Does the rule let enough room for manœuvre to fiscal policies to play their role of macroeconomic stabilization?
	<i>Transparency - Simplicity</i>	Is the functioning of the rule sufficiently transparent and simple, so as to gain "popular support"?
Enforceability	<i>Well-defined constraint</i>	Are the different components (process of implementation, sanctions, coverage, escape clauses, etc.) of the rule clearly defined, so as to avoid ambiguities?
	<i>"Bindingness" to the rule</i>	Is the rule easily amendable?
	<i>Timing of the monitoring compliance</i>	Ex ante and/or ex post?
	<i>Independence of the bodies in charge of the monitoring compliance</i>	Is the compliance with the rule monitored independently?

Source: Author's elaboration based on the criteria of Kopits and Symansky (1998: 18-19).

Before analysing the EU fiscal rule in the light of those criteria, one must keep in mind two elements. Firstly, quoting Creel (2003: 6), "the eight features might not be fulfilled at the same time by any set of fiscal rules all over the world; some "trade-offs" among them are likely, indeed "inevitable"". However, it does not mean that all possible trade-offs turn out to be equivalently effective, but rather

that the choice of emphasising one or the other criterion exists and is a matter of political will. More importantly, we wish to draw the reader's attention on the fact that the forthcoming qualitative assessment expresses our own viewpoint. Similarly, the decision of stressing in particular some aspects of the concerned fiscal rule is our own. Therefore, we do not pretend to provide an unquestionable opinion but, we try, nonetheless, to present a picture as objective as possible.

### *6.1.1 Criteria of efficiency*

#### *Consistency*

Analysing the consistency of the European fiscal constraint with its stated goals requires logically a clear understanding of those. However, this task appears to be more difficult as it seems at the first glance.

In fact, the target(s) pursued by the fiscal discipline instrument has (have) slightly changed over the years and the successive reforms, so that, in June 2013, a careful reading of the legal acts in force may reveal several distinctive goals. Next to the initial objective of "sound public finances" (interpreted as the avoidance of excessive levels of deficit and debt), we find now the will of avoiding macroeconomic imbalances, as well as of coordinating the national fiscal procedures and policies. Besides the fact that "it is very unlikely that one rule can achieve more than one objective" (Fatás *et al.*, 2003: 66), we wish to underscore one fundamental inconsistency, which has been widely documented since the first publication of the Maastricht criteria: the choice in the reference values.

The setting of the central reference values for deficit and debt at 3 and 60 per cent of GDP raises indeed some problems. As highlighted by de Grauwe (2009: 148), these thresholds have been derived from a well-known formula determining the maximal deficit required to stabilise the indebtedness level. Thereby, the calculation shows that a deficit of 3 per cent of GDP would stabilise the public debt at 60 per cent of GDP *"if and only if the nominal growth rate of GDP is 5*

*per cent*”<sup>105</sup>. As far as the consistency with the objective of sound public finances is concerned, this implies two incoherencies.

On the one hand, the assumption of a uniform growth rate within the EMU is questionable, if not simply wrong. For instance, in 2011, whereas France recorded an annual GDP growth rate of 2 per cent, the same figure grew at a rate of 8.3 per cent in Estonia (ec.europa.eu/eurostat). In clear, and without taking into account their respective initial level of public debt, if the objective consists in the sustainability of the public debt, the deficit of a slow-growing country like France should be largely closer to balance than the one of Estonia. The introduction of country-specific MTO and, more recently, of thresholds of structural deficit differentiated according to the level of debt (0.5 per cent of GDP, or 1 per cent of GDP under the condition that the debt ratio is “significantly” below 60 per cent) may be seen as an attempt to correct this inconsistency.

On the other hand, the choice of 60 per cent as the optimal level of debt appears to be quite arbitrary. The economic theory provides indeed no foundation justifying such threshold. In consequence, one may wonder why 3 and 60 and not 3.5 and 70 or 2.5 and 50; both combinations satisfying the formula. The answer to that question is to be found in the statistical series of Debt-to-GDP ratios exposed in Appendix D. The 60 per cent reference value corresponds actually to the average level of public indebtedness in the EA-12 in the early-1990s.

Although the role played by these reference values has evolved over the successive reforms, they are still at the heart of the European definition of fiscal discipline. Therefore, the fact that they lie upon the 1991 average public finance stance is quite disturbing in terms of signal. In our opinion, this constitutes a major inconsistency with the stated goal of “sound public finance”.

### *Credibility*

As far as the credibility of the European fiscal rules is concerned, we must emphasise the significant improvement realised with the introduction of the Six-Pack. The reversed qualified majority voting system, the commitment made by

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<sup>105</sup> The formula is the following:  $d = gb$ , where  $d$  is the public deficit (as a percentage of GDP),  $g$  is the annual growth rate of nominal GDP and  $b$  is the public debt (as a percentage of GDP). Accordingly,  $0.03 = 0.05 \times 0.6$ . For the development of the formula, see de Grauwe (2009:148).

the member states to respect the Commission's recommendations, or the specification of the different procedures of sanction (in the preventive arm, in the corrective arm, in the macroeconomic imbalances procedure, in the national implementation of numerical fiscal rules) contribute to restore the credibility that has been lost previously. Naturally, the rules in force provide many escape clauses and the effectiveness of the sanction has not been proved yet. In addition, these new legal acts still lie upon the same institutional foundation (for instance the provisions contained in the TFEU or the accounting standards of the ESA 95), which have been vehemently criticised<sup>106</sup>. Nonetheless, it seems that the EU legislator is now on the right path.

Although the last reforms go in the right direction and besides they were built on a questionable institutional ground, the credibility of a fiscal constraint also depends on what happened in the past and, in this case, the past does obviously not operate in favour of the EU fiscal instrument, which has showed little success until now. Caution is thus required, particularly since many provisions described in the last legal acts have still to be implemented.

#### *Adaptability - Flexibility*

The will of letting enough room for manoeuvre to fiscal policies to play their stabilisation role has always been present in the EU fiscal legislation. On paper, the existence of escape clauses, the setting of an acceptable deficit threshold, or the acknowledgement of the influence of economic good and bad times on the fiscal outcomes offer “sufficient margins for automatic stabilisers to be fully effective” (Creel, 2003: 10). Maybe due to the definitional ambiguities of some of those principles or the initial public finances stance – which never was “close to balance” – the experience shows a certain abusive use of these “exit doors”. So that, when required, the flexibility margins were already spent (van Riet, 2010: 9). One may thus argue that, for too long, the fiscal room for manoeuvre has been interpreted as “the standard”, rather than as “the upper limit” to be also respected in economic turmoil.

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<sup>106</sup> See for instance, Dafflon and Rossi (1999).

### *Transparency - Simplicity*

According to some authors<sup>107</sup>, it is its simplicity that makes the strength of the European fiscal rule. Quoting Creel (2003: 7), who analyses the rule in force at that time, “the SGP is the simplest rule, since it is related to a symbolic figure as well as to the most understandable public finance concept – the overall public deficit”. Besides the fact that the SGP did not operate any differentiation among the member states in the implementation of the criteria, which surely made it simpler and more transparent, we estimate that this enthusiasm should be slightly tempered.

Although the main outline of the rule seems quite simple and transparent at the first glance, our detailed description provided in Chapter 5 tends to show quite the opposite. The many definitional ambiguities, the long list of escape clauses, or the numerous – sometimes overlapping – procedures are far from making the functioning of the fiscal constraint straightforward. The attempt, made in the Two-Pack, of standardizing the national budgetary calendars and, more particularly, of removing the overlapping procedures may be interpreted as a proof of our argument and confirms the need for simplification.

#### *6.1.2 Criteria of enforceability*

Looking back at the past fiscal outcomes of the EU member states, it becomes obvious that there have been serious issues when it came to enforce the rules. As we have already mentioned, the last cycle of reforms, which began with the Six-Pack, addresses many shortcomings contained in the institutional arrangement in so far. Since the enforcement phase of these amendments has not been reached yet, we draw the reader’s attention on the fact that it is too soon to completely grasp their impact.

#### *Well-defined constraint*

Since the launching of the second stage towards the creation of the EMU, the design of the EU fiscal discipline instrument has always been surrounded by definitional ambiguities. For instance, while the TFEU already provided escape clauses (“exceptional and temporary”, “sufficiently diminishing”, taking into

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<sup>107</sup> See for instance Creel (2003), or Buti *et al.* (2003).

account “all other relevant factors”, etc.), none of those were strictly specified. Similarly, the Treaty set the exhaustive list of potential sanctions in case of non-compliance without addressing the question of their implementation. Although improvements have been made over the years and the amendments (“exceptional and temporary” has been lastly defined in the revised SGP, the Six-Pack specified the term “sufficiently diminishing” as well as the functioning of the sanction mechanism), some aspects remains unclear. Moreover, we estimate that the multiplication of the different procedures is not without making the whole constraint more complicated.

#### *"Bindingness" to the rule*

If the “bindingness” to the EU fiscal rule has to be assessed in the light of the number of its successive amendments, we understand easily that the result risks to be quite negative. Taking only into account the provisions of the SGP, their legal basis have been amended no less that three times between 1997 and 2011. Nevertheless, the closer link between the supranational European constraint and the national systems, initiated in the TSCG and reaffirmed in the Two-Pack, has good chances to make the whole arrangement more binding and, more importantly, less amendable.

#### *Timing of the monitoring compliance*

Originally the compliance with the Maastricht criteria was monitored exclusively *ex post*. The entrance into force of the SGP marked later the introduction of an *ex ante* mechanism, i.e. the preventive arm. Both preventive and corrective arms have been developed over the years. For instance, the former has been enriched with a procedure of sanction (Six-Pack), a process of national budgetary coordination, or a system of enhanced surveillance (Two-Pack). For its part, the fiscal corrective arm follows clear deadlines (SGP, and revised SGP) and provides earlier sanctions (Six-Pack). This issue is further addressed in forthcoming Subsection 6.2.3.

#### *Independence of the bodies in charge of the monitoring compliance*

Looking back at the failures of the SGP and its revised version, it seems that one of the main explanatory factors lies on the decision-making system. Although the

several monitoring procedures involved always the European Commission, the role of the latter was limited to an advisory function. The ultimate decision-making was reserved to the Council of the European Union, i.e. the member states. In that configuration, the agents subject to the constraint are simultaneously the guardians of the rule. This situation not only makes the imposition of sanctions very unlikely but it also weakens significantly the credibility of the whole instrument.

In order to remediate to this major shortcoming, the EU legislator had to find a way to suppress (in the best case, or, at least, reduce) the influence of the Council to the benefit of more automatic decision-making system. Among the measures going to that direction, we find for instance the introduction of the so-called system of reversed majority voting (Six-Pack), the involvement of the EU Court of Justice in the control over the integration at the national level of the EU fiscal provision (TSCG), or the reinforced position of the Commission in the new monitoring procedures (Two-Pack).

## **6.2 The degree of strictness of the EU fiscal constraint**

Whereas the previous set of criteria investigated more particularly the general features of the EU fiscal rule, the second analytical grid allows us to tackle in greater details some crucial and more “technical” issues.

As noted previously, our use of this analytical grid is slightly diverted from its original purpose, which consists in providing a uniform logical framework for comparing different fiscal rules within the same environment (for example the instrument of fiscal discipline in force in the Swiss cantons). Strictly implemented in the EU case, it would for instance allow comparing the translation of the European fiscal constraint within the different member states. We would thus confront the member states’ national fiscal rules with the sequence of questions. Ultimately, we would be able to estimate which national transpositions are the strictest in terms of fiscal discipline. In our case – the assessment of the EU *supranational* institutional framework – we find ourselves upstream. In other words, we do not have a benchmark, against which we could confront the EU fiscal constraint. Nevertheless, since this assessment method points out the crucial



issues that a fiscal rule should tackle, it remains meaningful to apply it to our case. Consequently, we do not entirely follow the sequence of questions presented in Subsection 4.4.2 and illustrated in Figure 4-3, but we rather concentrate on the issues, which are relevant to the EU situation.

#### *6.2.1 Is the fiscal discipline requirement prescribed by the law?*

The fundamental design of the EU instrument for fiscal discipline is laid down in the Treaty on the Functioning of the European Union and its related Protocols. Although it is formally a Treaty, the TFEU, as well as its annexed Protocols, is part of the EU *primary law*, whose content may be materially considered as of constitutional nature (Dutheil de la Rochère, 2010: 86).

In addition to these primary law principles, several legislative acts of *derived law* complete the fiscal discipline requirement. We find indeed many EU regulations and one directive. As already mentioned in Chapter 5, the former legislative acts are binding and directly applicable in all member states. Also binding, “as to the result to be achieved”, the directive leaves however to the member states “the choice of form and methods” (Art. 288 TFEU).

Moreover, as required by the TSCG, the Eurozone member states should introduce by January 2014 a numerical fiscal rule, similar to the one prescribed at the EU level, into their national laws and preferably into their constitutions.

Finally, the functioning of the EU fiscal constraint provides that the EU institutions, mostly the Council and the Commission, formulate regular recommendations, opinions, or decisions. One must therefore be aware that, among these acts, only the decisions have binding force.

#### *6.2.2 What is the definition of the fiscal discipline?*

Our institutional description of the EU fiscal instrument shows quite clearly that the European definition of fiscal discipline differs from the concepts, inspired by the economic theory and exposed in Section 4.1. Likewise the institutional arrangement, the European interpretation of fiscal discipline has evolved over the years. While, in the 1990s, fiscal discipline was associated to the respect of the deficit and debt thresholds, the concept involves now numerous other figures, as

well as further requirements. Thereby, in 2013, the assessment of the fiscal discipline of a member state depends on many aspects. Let us thus try to summarize shortly the criteria of fiscal discipline.

At the national level firstly, the entrance into force of the TSCG marked the commitment of the member states to introduce in their own legislation a numerical fiscal rule. The latter should require that the annual structural deficit does not breach 0.5 per cent of GDP (1 per cent of GDP, if the debt-to-GDP ratio is significantly below 60 per cent).

In parallel, the provisions of the TFEU and the Six-Pack remain. According to these texts, a deficit is considered as “excessive” when the deficit-to-GDP ratio<sup>108</sup> and/or the debt-to-GDP ratio exceed respectively 3 and 60 per cent (TFEU). As far as the indebtedness measure is concerned, a breaching of the threshold is acceptable, as long as it records a sufficient annual decrease (Six-Pack).

Moreover, in order to minimize the chances to face such fiscal situation, the member states have to comply with “preventive requirements”. First of all, the structural deficit of a member state should be ideally below 1 per cent of GDP. If it is not the case, this target should be noted down as a “medium-term objective” (MTO), which implies that the concerned member states plan minimal annual adjustments measures. Accordingly, the MTO should schedule an annual improvement of the budget balance of at least 0.5 per cent of GDP (or higher, if their indebtedness level breaches the threshold). Secondly, the expenditure and revenue figures of the member states must also fulfil some conditions. Basically, the rule is that the annual expenditure growth does not exceed a reference medium term rate of potential GDP growth. The eventual excess of the expenditure growth should be matched by a revenue increase.

One last aspect of the European definition of the notion of fiscal discipline should be emphasised. One must indeed keep in mind that all above-mentioned principles provide potential escape clauses. Generally speaking, those are founded on the occurrence of “exceptional and temporary situations” or “special circumstances”.

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<sup>108</sup> Contrasting with the provision of the TSCG, here, the deficit figure does not refer to the annual cyclically-adjusted balance net of one-off and temporary measures, but to the accounting item B.9 in ESA 95 accounting plan: “net lending (+)/net borrowing (-)”.

In the same vein, their compliance monitoring involves, most of the time, the consideration of other parameters, indirectly related to fiscal policy. For instance, when investigating the existence of excessive deficit, the TFEU (Art. 126(3)) stipulates that, apart from the deficit and debt level, the Commission should take into account “all other relevant factors”. Updated in the Six-Pack reform, these factors encompass non-exhaustively the potential economic growth, the private sector net saving and debt position, the level of primary balance, the financial guarantees link with the financial sector, or the implicit liabilities related to ageing population. Together, the existence of these “exit doors” tends to dilute the definition given to fiscal discipline and, in consequence, exposes it to partisan interpretations.

### 6.2.3 *What does the fiscal discipline requirement concern?*

As expected in view of the European “multifaceted” definition of the concept of fiscal discipline, the object of the constraint is not unique. Besides the two types of requirement presented in Subsection 4.2.2, namely the distinction between *ex ante* and *ex post* requirements, the EU fiscal rules concern different figures.

As far as the “timing” of the constraint is concerned, the implementation of the Maastricht criteria is endowed with *ex ante*, as well as *ex post* requirements. Looking first at the *ex ante* mechanism, Chapter 5 showed that two processes of control coexist: partly the so-called preventive arm (last reviewed in the Six-Pack) and the assessment of the national budgetary drafts (introduced by the Two-Pack). Whereas the former instrument consists in the general assessment by the Council of the country-specific stability programmes for the three forthcoming years, the latter requires the Commission’s approval of the national budgets before their adoptions by the parliaments. Regarding now the *ex post* procedure, we find, on the one hand, the monitoring of the implementation of the above-mentioned stability programmes (the “*ex post* side” of the preventive arm) and, on the other hand, the corrective arm, which is triggered in case of excessive deficit.

In addition to these procedural distinctions, the aggregates or set of figures, subject to the successive controls, are also differentiated. Table 6-2 illustrates this situation and reviews which factors and aspects are examined at each step.

Table 6-2: *The fiscal procedures and their focus.*

Procedure		Figures and factors concerned
Ex ante	Assessment of the stability programme	Budgetary <b>MTO (structural balance)</b> and its adjustment path
		Expected path of the <b>general government debt</b>
		Expected growth path of the <b>government expenditure and revenue</b>
		<b>Implicit liabilities</b>
		Main <b>economic assumptions</b> and their impact on budgetary and debt position
		Cost-benefit analysis of the planned <b>structural reforms</b>
	Assessment of the national budgetary drafts	Planned <b>annual budget balance</b> for the general government (and its subsectors) in percentage of GDP
		Measures of planned <b>expenditure and revenue</b> for the general government (and its subsectors)
		Economic <b>assumptions</b> and <b>methodology</b>
Ex post	Monitoring of the implementation of the stability programme	Significant deviation from the planned <b>structural balance</b>
		Significant deviation from the expected <b>expenditure developments</b>
	Detection of excessive deficit	<b>Deficit-to-GDP ratio</b> (defined according to the ESA 95)
		<b>Debt-to-GDP ratio</b> (defined according to the ESA 95)
		<b>National economic situation</b> (potential occurrence of "exceptional circumstances")
		Other <b>relevant factors</b> (measures demonstrating the development in the medium-term economic, budgetary and debt position)

#### 6.2.4 In case of violation, does the rule provide sanction mechanism?

Although the first draft of the Maastricht criteria already assigned to the Council the power of imposing a range of sanction measures (Art. 126(11) TFEU), the significant incompleteness in the definition of those penalties, as well as in their modalities of implementation, has been quickly perceived. Aware of these limits, the European legislators amended the system of sanction in 1997 and in 2011. Schematically, the initial SGP specified firstly the timing of the imposition of sanctions. The same legal act set secondly a certain hierarchy in the use of the possible measures. For instance, it says that the Council should start, as a rule, with the non-interest bearing deposit. Observing the inefficient enforceability of the sanctions, the Six-Pack introduced later interesting new features, which do not really change the types of sanctions, but innovates in terms implementation.

Thereby, putting side the additional sanction mechanism provided by the TSCG<sup>109</sup> and the closer monitoring imposed on member states incurring financial difficulties by the Two-Pack legislation, it is the Six-Pack that constitutes today the main legal base for the procedure of sanctions. Let us thus summarize shortly the mechanism in force in 2013.

The Six-Pack defines four different situations leading to three types of sanctions. First of all, the *ex post* monitoring phase of the preventive arm may now lead to a sanction. Indeed, where a member state records a significant deviation with its stability programme and does not take the adequate measures to correct the situation, it risks an *interest-bearing deposit* of 0.2 per cent of GDP. Secondly, within the corrective arm, the sanction mechanism is articulated into two steps. To begin with, the confirmation of the existence of an excessive deficit by the Council triggers the imposition on the concerned member state of a *non-interest bearing deposit* of 0.2 per cent of GDP. Then, if no effective action has been undertaken within six months, the latter deposit should be converted into a *fine*. The last potential reason justifying to sanction a member state consists in manipulation of its statistics. In this case, the punishment provided by the Six-Pack is a fine of 0.2 per cent of GDP at most.

As mentioned previously, it is not in the form of the sanctions, but rather in the modalities of enforcement that the Six-Pack innovates. In fact, apart from the fine in case of falsification of public statistics, all other sanctions are now decided by *reversed qualified majority*. In other words, these measures should be implemented *unless* a qualified majority of the Council (without the concerned member state) rejects them. Sometimes referred to as a “semi-automatic” sanction mechanism, this system must still prove its effectiveness since the ultimate decision-making remains in the hands of the member states, which are simultaneously subject to the rules.

Finally, let us shortly tackle a further issue related to sanction mechanisms. Assuming that the enforcement of the penalties for non-compliant member states is ensured, one may then wonder if those are the most prone either to discourage

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<sup>109</sup> In the TSCG, it is stipulated that the Court of Justice could impose a penalty payment on the member states that have not introduced numerical fiscal into their national legislation.

the member states to break the rules, or to rectify their non-compliant position with one or another above-mentioned principle. In other words, in the EU case, the remaining question is the following: do the deposits and fines create the desired incentives? For instance, whereas a financial fine may be justified for punishing the manipulation of statistics, is such measure adequate in order to encourage a member state to promptly correct an excessive deficit? The same questioning makes also sense regarding the sanctions consisting in interest-bearing and non-bearing deposits. Acknowledging that they may dissuade to breach the rules, these types of penalties do not contribute in fixing the problems. On the contrary, they are likely to make the situation worse, which is more disturbing. In that sense, the implicit sanction in force during the convergence period – the participation in the EMU was conditioned to the soundness of the member states' public finances – was an instructive experience: on the one hand, the exclusion of the EMU was seen as a serious threat (like a fine) and, on the other hand, if the member state was able to comply with the requirement, the qualification to the monetary union constituted a reward.

Without entering into greater details, we would like though to point out that, besides their modalities of implementation, the choice of the sanctions might have an impact on the outcome of the fiscal discipline instrument. Therefore, it would be surely interesting to investigate to what extent the past failures of the European fiscal rules were due to the types of sanction provided, instead of the lack of enforceability.

## CONCLUSION

The fundamental purpose of the present Master's Thesis consisted in the description and the assessment of the fiscal constraint in force nowadays at the European level. In order to reach this ambitious target, we investigated not only the institutional design of the EU instrument of fiscal discipline, but also the economic theoretical foundations related to our matter. Thereby, we have been able to confront the lessons learned from the theory with the existing mechanism. Moreover, since the EU fiscal arrangement results from a twenty-year construction, we opted for a dynamic description of the EU fiscal environment. Instead of simply studying the legal bases in force at the time of writing, we tried to track as precisely as possible their evolution, pointing out the successive changes.

Organised in two parts and six chapters, our study has covered a wide range of fiscal issues and questions. As a conclusion, let us thus briefly sum up our main results, expose some of the challenges that the EMU will have to take up in a foreseeable future, and sketch a potential further research agenda.

After having contextualised the role of national fiscal policies in a supranational monetary union through Mundell's OCA model and acknowledged the relevance of the institutional environment in the functioning of any fiscal restriction, Part I developed, from a theoretical perspective, three aspects related to the concept of fiscal discipline: the debate on the interpretation of the concept of fiscal discipline, the ins and outs of imposing fiscal discipline with legally binding rules, and an overview of the different types of fiscal institutions.

To begin with, Chapter 1 reviewed the fundamental theoretical debate between the defenders of a strict fiscal control and the partisans of a more relaxed interpretation of fiscal discipline. Structuring the presentation according to Musgrave's public sector functions – resource allocation, income redistribution, macroeconomic stabilisation – we put in parallel the arguments of both opinions. Without leading to a clear-cut specification of the concept of fiscal discipline, this survey of the economic literature allowed us highlighting the advantages and disadvantages linked to the implementation of a certain degree of control over

fiscal policies. Besides the few drawbacks that such fiscal restriction may imply – especially regarding the limit it sets on the macroeconomic stabilisation function – the discussion showed that, in terms of resource allocation and income redistribution, fiscal discipline brings valuable benefits. In addition, we argued that the use of fiscal measures for stabilisation was questionable for practical reasons (low and shared investment capacities among government layers, low political incentives for contra-cyclical fiscal policies in period of economic prosperity, etc.). In consequence, we deemed that, on the basis of the economic theory, a certain degree of fiscal discipline was desirable; the precise “strictness” of the latter being however left undefined.

Whereas Chapter 1 dealt with the problem of controlling or not fiscal behaviours, Chapter 2 tackled the issue of the enforcement of this control. Put differently, this second chapter investigated to what extent legally binding rules represent adequate measures in order to ensure the respect of the concept of fiscal discipline adopted by, or imposed on a jurisdiction. Maybe redundant in appearance with the previous debate, the question of introducing or not legal commitments finds its justification from the fact that it requires taking into account another line of reasoning, including for instance public choice considerations. Moreover, since binding fiscal rules, taken in their broad sense, can be defined as institutional modifications of the environment framing the decision-making processes, we needed to understand more precisely the nature and the impact of these changes. Thereby, our analysis of the binding rules allowed us, not only to grasp their advantages (limitation of the deficit bias and the moral hazard phenomena, reinforcement of the budgetary pressure through the sanctions, etc.), but also to point out some weaknesses inherent to such instruments. We argued for instance that imposing legally binding requirements might potentially induce nontransparent behaviours, such as “creative accounting”, or that their enforceability (especially of the sanction mechanisms) may be difficult. Without leading to a total rejection of this kind of constraining measures, this chapter contributed to highlight the risks related to rule-based fiscal restrictions, as well as the aspects that require a particular attention when analysing fiscal rules.



The last chapter of Part I provided finally an overview of what the economic literature refers to as “fiscal institutions”. Accordingly, we dedicated the three first sections of Chapter 3 to the different kinds of “institutions” usually studied by the authors. We distinguished thus: the electoral rules, the budgetary institutions encompassing the several steps going from the formulation of a budget proposal to its concrete implementation, and the so-called numerical fiscal rules, which prescribe specific targets on the public budgets/accounts. More than just describing these institutions, we tried to determine, for each of them, their expected theoretical impact on fiscal outcome. Last but not least, this third chapter briefly portrayed some specificities of the Swiss institutional environment. Indeed, similarly to the above-mentioned institutions, the systems of referendums and of popular initiatives may be seen as additional “rules of the game”, which are likely to have an impact on the institutional environment and, *in fine*, on the fiscal outcomes.

Following the presentation of the theoretical background, Part II got into the substance of our matter, namely the description of the EU instrument of fiscal discipline. However, before investigating the European fiscal legislations, Chapter 4 served us as a transition between the lessons learned from the economic theory and the concrete analysis of the European concept of fiscal discipline. In fact, the fourth chapter of our study tackled successively two main issues. Given the relative definitional ambiguities, we needed indeed to specify some central fiscal notions (deficit, debt, investment, amortisation, etc.). Moreover, the second prerequisite for assessing a fiscal constraint consisted in defining an analytical grid gathering the relevant criteria.

As far as the clarification of the fiscal notions was concerned, we articulated our development in three steps. Firstly, we presented the theorem of balanced budget. Based on theoretical arguments, the four principles that this theorem counts give the guidelines for reaching an adequate fiscal equilibrium. From these guidelines, we formalized the so-called revisited “golden rule” of public finances. At once elegant and simple, this “golden rule” illustrates the principles that should govern the investment and borrowing decisions. Translated into practice, the respect of those requires a well-defined public accounting plan. Therefore, the last step

consisted in the presentation of a standard accounting framework. Rather than focusing on the bookkeeping methods, we focused, on the one hand, on the features specific to the public sector and, on the other hand, on the calculation of the deficit and debt aggregates.

Having specified the concept of fiscal discipline, as well as developed a set of criteria allowing the assessment of any fiscal constraint, we could finally expose our study of the European case in a fifth chapter. So, starting from the initial convergence criteria laid down in the Maastricht Treaty, the six sections of Chapter 5 described and dissected in details the successive reforms and adaptations that the EU fiscal rules have known over the years. More than just gathering all related legal acts and transcribing their provisions chronologically, we tried to carry a deeper analysis and provide a complete institutional reading of this supranational fiscal constraint. Accordingly, we examined not only the organisation of the several procedures prescribed by the legislations (EDP, preventive arm, corrective arm, MIP, etc.), but we also investigated the economic meaning and content of the targeted fiscal aggregates (size of the public sector, EU accounting plan, etc.). Besides, aware of the relevance of the public choice approach in the assessment of any institutional arrangement, we regularly emphasised some central aspects, such as the political backgrounds of the reforms, the decision-making rules governing the procedures, or the various incentives faced by the member states.

Last but not least, Chapter 6 reviewed and assessed the EU instrument of fiscal discipline that is in force nowadays. As a first step, we provided an assessment based on the eight criteria defined in Chapter 4. Covering two fundamental properties – the efficiency and the enforceability – our evaluation tackled successively the consistency, the credibility, the adaptability, the transparency, the definitional clarity, the bindingness, the timing of the control and the independence of the monitoring bodies. Following this first review, we addressed four more questions inspired from Dafflon's assessment method<sup>110</sup>. On this occasion, we investigated further the concept of fiscal discipline, which is actually

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<sup>110</sup> See Subsection 4.2.2.

implemented at the European level. We also reviewed the several aggregates targeted in each procedure. Finally, we summed up the different potential sanctions, as well as their enforcement mechanism.

Generally speaking and without restating each conclusion and remark formulated along the final assessment, we wish to emphasise that our research indicates that a general improvement of the European fiscal constraint occurred these last years. Initiated with the publication of the Six-Pack, the last reforms showed a clear will for erasing past flaws. For instance, the introduction of the reversed qualified majority voting system in many decision-making processes illustrates perfectly our point. However, this optimism should be slightly tempered in view of some remaining uncertainties and problems. First of all, one must note that the fiscal requirements in force nowadays is nothing less than the result of an overlapping institutional construction, whose foundations contain a certain number of inconsistencies. Secondly, many of the new provisions, deemed promising, are still in their implementation phase. Furthermore, their success will strongly depend on the member states' willingness to integrate them adequately in their respective legislations. Symbolizing our reserves, the national numerical fiscal rules prescribed by the TSCG and the Two-Pack have to be implemented by the Eurozone participants by the end of 2013/beginning of 2014. Therefore, this next step should be attentively followed and will, for sure, condition the success of the most recent reforms.

We would like finally to draw the reader's attention on the fact that the present Master's Thesis reviewed and assessed the EU supranational institutional environment, in which national fiscal policies are designed. Consequently, further investigations regarding the national fiscal rules would be required in order to obtain a full image of the fiscal constraint in force in the European Union. Besides completing our study, this exercise would allow a comparison of the different national fiscal discipline instruments. We could thereby measure the "strictness" of the national interpretations of fiscal discipline, as well as confront the different system with their respective fiscal outcomes.

## APPENDICES

### Appendix A: Investment expenditures in Switzerland by layer of government

Year	Investment expenditures, in 1'000 CHF				Total expenditure of the public sector, in 1'000 CHF	Public sector investment / total expenditures
	Confederation	Cantons	Municipalities	Public sector		
1	2	3	4	5	6	7 (= 5/6)
1990	3'500'434	6'625'022	5'822'881	12'425'650	105'118'888	11.82%
1991	4'383'969	7'001'116	6'106'651	13'535'306	117'006'922	11.57%
1992	4'165'566	7'103'845	6'379'687	14'068'469	127'281'198	11.05%
1993	7'162'597	9'670'103	5'870'762	18'908'598	139'891'798	13.52%
1994	5'692'742	8'686'967	5'975'204	16'473'754	140'603'608	11.72%
1995	4'539'752	7'308'684	5'872'503	13'819'176	139'873'305	9.88%
1996	5'432'562	7'929'515	5'498'494	15'221'875	145'496'495	10.46%
1997	6'582'739	8'690'571	5'306'312	17'051'506	149'994'297	11.37%
1998	6'289'453	8'152'338	5'633'922	16'436'040	151'390'909	10.86%
1999	5'616'577	7'302'339	5'274'839	14'398'060	148'940'137	9.67%
2000	6'550'596	7'506'021	5'235'336	15'809'157	151'836'715	10.41%
2001	8'106'891	7'670'698	5'243'838	17'633'313	160'553'803	10.98%
2002	7'729'345	8'017'873	5'257'007	17'606'898	166'501'874	10.57%
2003	6'732'780	7'034'366	5'642'358	16'072'856	169'862'602	9.46%
2004	6'669'284	6'745'374	5'435'846	15'755'063	173'089'360	9.10%
2005	6'721'387	6'628'453	5'274'570	15'795'167	176'235'767	8.96%
2006	6'011'441	6'770'184	5'276'093	15'473'702	176'973'488	8.74%
2007	6'557'720	7'203'505	5'375'718	15'786'403	183'706'306	8.59%
2008	13'152'724	6'601'601	6'551'737	23'969'370	187'890'993	12.76%
2009	7'647'245	6'737'520	6'995'459	19'214'741	185'536'151	10.36%
2010	7'539'014	7'193'265	6'877'047	19'390'733	189'407'520	10.24%

Source: col. 2: F11.7.4\_Ausgaben\_Bund (refresh: 20.08.2012); col.3:

F40.7.4\_Ausgaben\_Kantone\_KK\_insg (refresh 20.08.2012); col.4: F23.7.4\_Ausgaben\_G\_insg

(20.08.2012); col. 5 and 6: F80.7.4\_Ausgaben\_Staat\_21.08.2012 (refresh 21.08.2012); Documents

available at: <http://www.efv.admin.ch/f/dokumentation/finanzstatistik/berichterstattung.php>.

# Appendix B: Sample of the EDP notification tables<sup>111</sup>

**Table 1: Reporting of government deficit/surplus and debt levels and provision of associated data**

Member state: France Data are in ... (millions of units of national currency) Date: 11/10/2012	ESA 95 codes	Year				
		2008	2009	2010	2011	2012
		finalized	finalized	half-finalized	estimated	planned
<b>Net borrowing (-)/ net lending (+)</b>	EDP B.9					
General government	S.13	-64,299	-142,223	-136,966	-103,324	-91,997
- Central government	S.1311	-68,402	-121,472	-112,325	-89,908	-79,508
- State government	S.1312	M	M	M	M	M
- Local government	S.1313	-9,430	-5,939	-1,359	-949	-2,086
- Social security funds	S.1314	13,533	-14,812	-23,282	-12,467	-10,403
<b>General government consolidated gross debt</b>						
<b>Level at nominal value outstanding at end of year</b>		finalized	finalized	half-finalized	estimated	planned
<i>By category:</i>						
Currency and deposits	AF.2	26,423	23,742	23,080	30,033	
Securities other than shares, exc. financial derivatives	AF.33	1,104,006	1,262,630	1,347,043	1,471,173	
Short-term	AF.331	153,558	233,228	212,119	226,026	
Long-term	AF.332	950,448	1,029,402	1,134,924	1,245,147	
Loans	AF.4	188,172	207,069	224,911	215,760	
Short-term	AF.41	13,213	19,261	28,353	8,518	
Long-term	AF.42	174,959	187,808	196,558	207,242	
<b>General government expenditure on:</b>						
Gross fixed capital formation	P.51	62,698	64,355	60,405	61,382	62,146
Interest (consolidated)	EDP D.41	56,283	45,350	46,569	52,024	50,588
<i>p.m.: Interest (consolidated)</i>	D.41 (uses)	56,609	45,757	46,955	52,598	50,899
<b>Gross domestic product at current market prices</b>	B.1*g	1,933,195	1,885,763	1,937,261	1,996,583	2,036,016

(1) Please indicate status of data: estimated, half-finalized, final.

<sup>111</sup> The bi-annual full documents of each EU member states are available on: [http://epp.eurostat.ec.europa.eu/portal/page/portal/government\\_finance\\_statistics/excessive\\_deficit/edp\\_notification\\_tables](http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/excessive_deficit/edp_notification_tables).

**Table 2A: Provision of the data which explain the transition between the public accounts budget balance and the central government deficit/surplus**

Member state: France Data are in ... (millions of units of national currency) Date: 1/10/2012		Year			
	2008	2009	2010	2011	2012
<b>Working balance in central government accounts</b>	-56,270	-138,027	-148,804	-90,719	-83,557
<i>Basis of the working balance</i>	cash	cash	cash	cash	cash
Financial transactions included in the working balance					
Loans, granted (+)	-1,348	10,546	27,660	2,610	6,563
Loans, repayments (-)	1,282	9,245	4,891	7,203	1,807
Equities, acquisition (+)	-1,140	-746	-2,849	-4,377	-954
Equities, sales (-)	680	1,601	1,003	1,169	7,894
Other financial transactions (+/-)	-1,269	0	-180	-386	-768
of which: transactions in debt liabilities (+/-)	-601	446	24,795	-1,017	-1,416
Detail 1	L	L	L	L	L
Detail 2					
Non-financial transactions not included in the working balance	-7,314	3,000	520	-1,816	-167
Detail 1					
Detail 2					
Difference between interest paid (+) and accrued (EDP D 41)(-)	393	-557	-917	606	1,750
ICNE et gains/pertes sur adjudications					
Other accounts receivable (+)	1,457	5,543	-1,237	2,076	1,667
Detail 1	-456	3,928	460	-1,380	123
Detail 2	1,913	1,615	-1,697	3,456	1,544
Other accounts payable (-)	-491	2,440	1,021	-275	-1,229
Detail 1	-913	2,025	127	500	0
Detail 2	422	415	894	-375	-1,229
Décalage comptable éco. cot. sociales autres					
Working balance (+/-) of entities not part of central government	0	0	0	0	L
Net borrowing (-) or net lending (+) of other central government bodies	-5,149	-4,633	9,061	-2,721	-4,837
Detail 1					
Detail 2					
Other adjustments (+/-) (please detail)					
Detail 1	320	216	371	329	311
Detail 2	320	216	371	329	311
Detail 3					
Detail 4					
Detail 5					
<b>Net borrowing (+)/lending(-) (EDP B 3) of central government (S 1311)</b>	<b>-66,402</b>	<b>-121,472</b>	<b>-112,325</b>	<b>-89,906</b>	<b>-79,508</b>
(ESA 95 account)					

(1) Please indicate accounting basis of the working balance: cash, accrual, mixed, other.

Note: Member States can adapt tables 2A, B, C and D to their national specificity according to the established practice

Table 3A: Provision of the data which explain the contributions of the deficit/surplus and the other relevant factors to the variation in the debt level (general government)

Member state: France Data are in : (millions of units of national currency) Date: 11/10/2012	Year			
	2008	2009	2010	2011
<b>Net borrowing/(+lending)-(EDP B.9) of general government (S.13)<sup>1</sup></b>	<b>64,299</b>	<b>142,223</b>	<b>136,996</b>	<b>103,324</b>
<b>Net acquisition (+) of financial assets <sup>(2)</sup></b>	<b>40,309</b>	<b>49,148</b>	<b>-18,670</b>	<b>30,109</b>
Currency and deposits (F.2)	16,546	16,972	-17,540	19,684
Securities other than shares (F.3)	15,321	-6,473	2,098	-753
Loans (F.4)	-1,359	7,543	2,930	7,292
Increase (+)	13,626	19,494	21,086	15,470
Reduction (-)	-14,985	-17,951	-18,758	-8,178
Short term loans (F.41), net	-68	276	-425	-469
Long-term loans (F.42)	-1,291	7,267	3,355	7,761
Increase (+)	6,403	10,548	14,491	12,278
Reduction (-)	-7,894	-3,381	-13,046	-4,517
Shares and other equity (F.5)	5,223	11,405	-9,776	-3,659
Portfolio investments, net <sup>(3)</sup>	5,106	8,185	-8,015	-4,405
Shares and other equity other than portfolio investments	117	3,220	-1,761	546
Increase (+)	3,000	33,420	1,078	547
Reduction (-)	-883	-10,200	-2,809	-1
Other financial assets (F.1, F.6 and F.7)	4,668	19,701	3,618	13,775
<b>Adjustments <sup>(4)</sup></b>	<b>2,340</b>	<b>-16,531</b>	<b>-16,703</b>	<b>-13,501</b>
Net insurance (-) of liabilities in financial derivatives (F.34)	-12	46	-264	5
Net insurance (-) of other liabilities (F.5, F.6 and F.7)	-281	-11,396	-8,220	-15,001
Issuances above/(below)(+) nominal value	2,277	-4,233	-8,291	-2,474
Difference between interest (EDP D.41) accrued(-) and paid <sup>(5)</sup> (+)	12	-1,391	-559	844
of which: interest flows attributable to swaps and FRAs	0	0	0	0
Redemptions of debt above/(below)(-) nominal value	373	268	589	3,108
Appreciation/(depreciation)(-) <sup>(6)</sup> of foreign-currency debt <sup>(4)</sup>	2	1	-1	1
Changes in sector classification (K.12.1) <sup>(5)</sup> (+/-)	0	0	0	0
Other volume changes in financial liabilities (K.7, K.8, K.10) <sup>(6)</sup> (-)	-31	174	44	16
<b>Statistical discrepancies</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
Difference between capital and financial accounts (B.9-B.9f)	0	0	0	0
Other statistical discrepancies (+/-)	0	0	0	0
<b>Change in general government (S.13) consolidated gross debt <sup>(1,3)</sup></b>	<b>107,038</b>	<b>174,840</b>	<b>101,593</b>	<b>121,932</b>

\*Please note that the sign convention for net borrowing / net lending is different from tables 1 and 2.

(1) A positive entry in this row means that nominal debt increases, a negative entry that nominal debt decreases.

(2) Consolidated within general government.

(3) Due to exchange-rate movements.

(4) Including capital uplift

(5) AF.2, AF.33 and AF.4. At face value.

Table 4: Provision of other data in accordance with the statements contained in the Council minutes of 22/11/1993.

Statement Number	Member state: France Data are in ... (millions of units of national currency) Date: 11/10/2012	Year				
		2008 (1)	2009 (1)	2010 (1)	2011 (1)	2012 forecast
2	Trade credits and advances (AF.71 L)	62,056	65,937	66,164	67,030	L
3	Amount outstanding in the government debt from the financing of public undertakings					
	<i>Data:</i>	L	L	L	L	L
	<i>Institutional characteristics:</i>					
4	In case of substantial differences between the face value and the present value of government debt, please provide information on i) the extent of these differences:  ii) the reasons for these differences:					
10	Gross National Income at current market prices (B.5*2)(2)	1,967,248	1,920,577	1,974,228	2,034,214	L

(1) Please indicate status of data: estimated, half-finalized, final.  
(2) Data to be provided in particular when GNI is substantially greater than GDP.



## Appendix C: Deficit-to-GDP ratios of the EMU member states.

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Belgium	-7.4	-8.1	-7.5	-5.1	-4.5	-4	-2.2	-0.9	-0.6	0	0.4	-0.1	-0.1	-0.1	-2.5	0.4	-0.1	-1	-5.5	-3.8	-3.7
Germany	-2.9	-2.5	-3	-2.3	-9.5	-3.4	-2.8	-2.3	-1.6	1.1	-3.1	-3.8	-4.2	-3.8	-3.3	-1.6	0.2	-0.1	-3.1	-4.1	-0.8
Estonia	-	-	9.7	4.4	1.1	-0.3	2.2	-0.7	-3.5	-0.2	-0.1	0.3	1.7	1.6	1.6	2.5	2.4	-2.9	-2	0.2	1.1
Ireland	-2.8	-2.8	-2.6	-1.8	-2.2	-0.3	1	2.2	2.6	4.7	0.9	-0.4	0.4	1.4	1.7	2.9	0.1	-7.4	-13.9	-30.9	-13.4
Greece	-9.9	-11	-12	-8.3	-9.1	-6.7	-5.9	-3.9	-3.1	-3.7	-4.5	-4.8	-5.7	-7.6	-5.5	-5.7	-6.5	-9.8	-15.6	-10.7	-9.4
Spain	-	-	-	-	-7.2	-5.5	-4	-3	-1.2	-0.9	-0.5	-0.2	-0.3	-0.1	1.3	2.4	1.9	-4.5	-11.2	-9.7	-9.4
France	-3	-4.6	-6.5	-5.5	-5.5	-4	-3.3	-2.6	-1.8	-1.5	-1.6	-3.3	-4.1	-3.6	-2.9	-2.3	-2.7	-3.3	-7.5	-7.1	-5.2
Italy	-11.3	-10.3	-10	-9	-7.4	-7	-2.7	-2.7	-1.9	-0.8	-3.1	-3.1	-3.6	-3.5	-4.4	-3.4	-1.6	-2.7	-5.4	-4.5	-3.9
Cyprus	-	-	-	-	-0.9	-3.2	-5.1	-4.2	-4.3	-2.3	-2.2	-4.4	-6.6	-4.1	-2.4	-1.2	3.5	0.9	-6.1	-5.3	-6.3
Luxembourg	0.7	-0.2	1.5	2.5	2.4	1.2	3.7	3.4	3.4	6	6.1	2.1	0.5	-1.1	0	1.4	3.7	3.2	-0.8	-0.8	-0.3
Malta	-	-	-	-	-3.8	-8.2	-7.7	-10	-7.2	-5.8	-6.4	-5.8	-9.2	-4.7	-2.9	-2.8	-2.3	-4.6	-3.9	-3.6	-2.7
Netherlands 1)	-2.7	-4.2	-2.8	-3.5	-4.3	-1.9	-1.2	-0.9	0.4	2	-0.2	-2.1	-3.1	-1.7	-0.3	0.5	0.2	0.5	-5.6	-5.1	-4.5
Austria	-2.9	-2	-4.4	-4.9	-5.8	-4	-1.8	-2.4	-2.3	-1.7	0	-0.7	-1.5	-4.4	-1.7	-1.5	-0.9	-0.9	-4.1	-4.5	-2.5
Portugal	-6.9	-4.4	-7.4	-7.1	-5.4	-4.9	-3.7	-3.9	-3.1	-3.3	-4.8	-3.4	-3.7	-4	-6.5	-4.6	-3.1	-3.6	-10.2	-9.8	-4.4
Slovenia	-	-	-	-	-8.3	-1.1	-2.3	-2.4	-3	-3.7	-4	-2.4	-2.7	-2.3	-1.5	-1.4	0	-1.9	-6	-5.7	-6.4
Slovakia	-	-	-30.9	-6.1	-3.4	-9.9	-6.3	-5.3	-7.4	-12.3	-6.5	-8.2	-2.8	-2.4	-2.8	-3.2	-1.8	-2.1	-8	-7.7	-4.9
Finland	-1	-5.5	-8.2	-6.7	-6.1	-3.4	-1.3	1.7	1.7	7	5.1	4.2	2.6	2.5	2.9	4.2	5.3	4.4	-2.5	-2.5	-0.6
<b>Euro area-17</b>	-	-	-	-	-7.2	-4.3	-2.8	-2.3	-1.5	-0.1	-2	-2.7	-3.1	-2.9	-2.5	-1.4	-0.7	-2.1	-6.3	-6.2	-4.1
<b>Euro area-12</b>	-	-	-	-	-7.3	-4.3	-2.8	-2.3	-1.5	0	-1.9	-2.6	-3.1	-2.9	-2.5	-1.4	-0.7	-2.1	-6.3	-6.2	-4.1
<i>Reference value</i>	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3

Note: 1) Not including for 1995 a net amount of 14.9 bn EURO-NLG of exceptional expenditure related to the reform of the financing of the social housing societies.

Source: European Commission (2012), **General Government data: General Government Revenue, Expenditure, Balances and Gross Debt**, Part II: Tables by series, Autumn 2012, Table 53B, pp. 154, available at: [http://ec.europa.eu/economy\\_finance/db\\_indicators/gen\\_gov\\_data/time\\_series/index\\_en.htm](http://ec.europa.eu/economy_finance/db_indicators/gen_gov_data/time_series/index_en.htm).

## Appendix D: Debt-to-GDP ratios of the EMU member states.

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Belgium	126.9	128.5	134.1	132.1	130.2	127.2	122.5	117.2	113.6	107.8	106.5	103.4	98.4	94	92	88	84	89.2	95.7	95.5	97.8
Germany	39.5	42	45.8	48	55.6	58.5	59.8	60.5	61.3	60.2	59.1	60.7	64.4	66.2	68.5	68	65.2	66.8	74.5	82.5	80.5
Estonia	-	-	-	-	8.2	7.6	7	6	6.5	5.1	4.8	5.7	5.6	5	4.6	4.4	3.7	4.5	7.2	6.7	6.1
Ireland	93.3	90.4	92.9	87.5	80.1	72.3	63.5	53	47	35.1	35.2	32	30.7	29.5	27.3	24.6	25	44.5	64.9	92.2	106.4
Greece	74	79.1	99.2	97.2	97.9	100.3	97.5	95.4	94.9	104.4	104.7	102.6	98.3	99.8	101.2	107.5	107.2	112.9	129.7	148.3	170.6
Spain	43.4	45.9	57.2	59.9	63.3	67.5	66.2	64.2	62.4	59.4	55.6	52.6	48.8	46.3	43.2	39.7	36.3	40.2	53.9	61.5	69.3
France	36	39.7	46	49.2	55.4	58	59.4	59.5	58.9	57.4	56.9	59	63.2	65	66.7	64	64.2	68.2	79.2	82.3	86
Italy	97.6	104.7	115.1	121.2	120.9	120.2	117.4	114.2	113	108.5	108.2	105.1	103.9	103.4	105.7	106.3	103.3	106.1	116.4	119.2	120.7
Cyprus	-	-	-	-	51.8	53.1	57.4	59.2	59.3	59.6	61.2	65.1	69.7	70.9	69.4	64.7	58.8	48.9	58.5	61.3	71.1
Luxembourg	4.1	4.8	6	5.5	7.4	7.4	7.4	7.1	6.4	6.2	6.3	6.3	6.1	6.3	6.1	6.7	6.7	14.4	15.3	19.2	18.3
Malta	-	-	-	-	35.3	40.1	48.4	53.4	57.1	54.9	60.5	59.1	67.6	71.7	69.7	64	61.9	62	67.6	68.3	70.9
Netherlands	76.6	77.3	78.5	75.7	76.1	74.1	68.2	65.7	61.1	53.8	50.7	50.5	52	52.4	51.8	47.4	45.3	58.5	60.8	63.1	65.5
Austria	56.4	56.3	60.9	64	68.2	68.1	64.1	64.4	66.8	66.2	66.8	66.2	65.3	64.7	64.2	62.3	60.2	63.8	69.2	72	72.4
Portugal	55.6	50	54.6	57.3	59.2	58.2	55.5	51.8	51.4	50.7	53.8	56.8	59.4	61.9	67.7	69.4	68.4	71.7	83.2	93.5	108.1
Slovenia	-	-	-	-	18.6	21.9	22.4	23.1	24.1	26.3	26.5	27.8	27.2	27.3	26.7	26.4	23.1	22	35	38.6	46.9
Slovakia	-	-	-	-	22.1	31.1	33.7	34.5	47.8	50.3	48.9	43.4	42.4	41.5	34.2	30.5	29.6	27.9	35.6	41	43.3
Finland	22.3	40.1	55.3	57.6	56.6	57	53.9	48.4	45.7	43.8	42.5	41.5	44.5	44.4	41.7	39.6	35.2	33.9	43.5	48.6	49
<b>Euro area-17 1)</b>	-	-	-	-	72	73.7	73.2	72.9	71.7	69.2	68.2	68.1	69.2	69.6	70.3	68.7	66.4	70.2	80	85.6	88.1
<b>Euro area-12 2)</b>	57.3	59.1	65	67.7	72.4	74.1	73.6	73.2	72	69.5	68.5	68.4	69.6	70	70.8	69.2	66.9	70.9	80.6	86.3	88.8
Reference value	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60

Notes: 1) Non consolidated for intergovernmental loans amounting to 0.9 bn EUR in 2009, 21.2 bn EUR in 2010 and 69.4 bn EUR in 2011; 2) Non consolidated for intergovernmental loans amounting to 0.9 bn EUR in 2009, 21.0 bn EUR in

Source: European Commission (2012), **General Government data: General Government Revenue, Expenditure, Balances and Gross Debt**, Part II: Tables by series, Autumn 2012, Table 55B, pp. 166, available at:

[http://ec.europa.eu/economy\\_finance/db\\_indicators/gen\\_gov\\_data/time\\_series/index\\_en.htm](http://ec.europa.eu/economy_finance/db_indicators/gen_gov_data/time_series/index_en.htm)

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